COUNTY OF SANTA CLARA

Report to Management

For the Fiscal Year Ended June 30, 2006
Finance and Government Operations Committee  
County of Santa Clara  
San Jose, California  

In planning and performing our audit of the basic financial statements of the County of Santa Clara (the County) for the fiscal year ended June 30, 2006, we considered the County's internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the basic financial statements and not to provide assurance on internal control. We did not audit the financial statements of the FIRST 5 Santa Clara County; the County Sanitation District 2 - 3 of Santa Clara County; the Santa Clara County Vector Control District; the Santa Clara County Central Fire Protection District; and Los Altos Hills County Fire District, which are included in the County's basic financial statements. Accordingly, this report does not cover these entities, except for a prior year recommendation related to the County Sanitation District 2 - 3 of Santa Clara County, which was implemented during the year.

During our audit, we noted certain matters involving internal controls and their operation, and are submitting, for your consideration, related recommendations designed to help the County make improvements and achieve operational efficiencies. Our comments reflect our desire to be of continuing assistance to the County. This letter does not affect our report dated November 28, 2006, on the basic financial statements of the County.

We will review the status of these comments during our next audit engagement. We have already discussed these comments and recommendations with various County personnel, and we will 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 the recommendations.

Additionally, we have included in this letter a summary of communications with the Finance and Government Operations Committee as required by professional auditing standards.

This letter is intended solely for the information and use of the Finance and Government Operations Committee, County management and others within the County and is not intended to be and should not be used by anyone other than these specified parties.

M. Macias Gini & O'Connell LLP  
Certified Public Accountants  
Walnut Creek, California  

November 28, 2006
COUNTY OF SANTA CLARA
Report to Management
For the Fiscal Year Ended June 30, 2006

REQUIRED COMMUNICATIONS

Professional auditing standards require auditors to communicate with the audit committee, or its equivalent, on a number of subjects. The following information satisfies these requirements, and is solely for use of the Finance and Government Operations Committee and County management.

I. The Auditor's Responsibility Under Auditing Standards Generally Accepted in the United States of America and OMB Circular A-133

As stated in our engagement communications dated April 17, 2006, our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement and are presented in accordance with U.S. generally accepted accounting standards. 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.

In planning and performing our audit, we considered the County's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide assurance on the internal control over financial reporting. We also considered internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with U.S. Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments and Non-Profit Organizations.

As part of obtaining reasonable assurance about whether the County's financial statements are free of material misstatement, we performed tests of the County's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit. Also, in accordance with OMB Circular A-133, we examined on a test basis, evidence about the County's compliance with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement, applicable to each of its major federal programs for the purpose of expressing an opinion on the County's compliance with those requirements. While our audit provides a reasonable basis for our opinion, it does not provide a legal determination of the County's compliance with those requirements.

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 County, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the County are described in Note 1 to the County's basic financial statements. As discussed in Note 1(p) to the basic financial statements, the County adopted Governmental Accounting Standards Board (GASB) Statement No. 42, GASB Statement No. 42, Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries. This statement establishes accounting and financial reporting standards for impairment of capital assets.
II. Significant Accounting Policies (Continued)

We noted no transactions entered into by the County during the year that were 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 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 are as follows:

- Accrual and disclosure of self insured claims liabilities
- Accrual and disclosure of compensated absences
- Depreciation estimates for capital assets, including depreciation methods and useful lives assigned to depreciable property
- Estimated contractual adjustments and bad debt allowances for patient accounts receivable
- Cost report settlements receivable and payable
- Unasserted claims and loss contingencies

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

- Estimates for worker's compensation, general liability, auto liability and malpractice liability were based on actuarial evaluations using historical loss and other data.
- Accrual and disclosures of compensated absences were based on accrued eligible hours of vacation and sick leave at current pay rates for eligible employees.
- Useful lives for depreciable property were determined by management based on the nature of the capital asset.
- Estimated contractual adjustments were based on prior cost report adjustments, previous regulatory settlements, and the potential future retrospective adjustments.
- Estimated bad debt allowances for patient accounts receivable were based on historical experience.
- Cost report settlement receivables and payables were based on analysis and interpretation of current regulations and adjustments to prior year cost report.
- Unasserted losses and claim contingencies were determined by attorney judgment about the ultimate outcome of the claim.

During our audit, we evaluated the key factors and assumptions used to develop the estimates in determining that they are reasonable in relation to the financial statements taken as a whole.
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 County'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 County, either individually or in the aggregate, indicate matters that could have a significant effect on the County's financial reporting process.

The County had an audit difference related to the timing of capital asset retirements in the amount of $1,033,000 decreasing the change in net assets of the County's major enterprise fund and the business-type activities for the current year. The County has determined that this effect is immaterial, both individually and in the aggregate, to the individual financial reporting units that collectively comprise the County's basic 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 basic 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 governmental unit'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. Major 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 County'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 our audit.
IX. Other Information in Documents Containing Audited Financial Statements

During the year, the County included audited financial statements or excerpts of audited financial statements in the official statements for fiscal year 2005/06 debt issues as follows:

- $149,740,000 Santa Clara Financing Authority Lease Revenue Bonds (Multiple Facilities Projects) 2006 Series I (Fixed Rate Bonds)
- $33,950,000 Santa Clara Financing Authority Lease Revenue Bonds (Multiple Facilities Projects) 2006 Series I (Auction Rate Securities)

We do not have an obligation to perform any procedures to corroborate other information contained in the official statements listed above. We were not associated with and did not have any involvement in these official statements. Accordingly, we did not perform any procedures on these documents and provide no assurance as to the other information contained in these official statements.
CURRENT YEAR COMMENTS

Financial Statement Reporting

Statement on Auditing Standards 112, Communicating Internal Control Related Matters Identified in an Audit (SAS 112) establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. Of the many recently issued auditing standards, SAS 112 will potentially have the most significant impact on the County's fiscal year 2006/07 audit. SAS 112 will require written communication to management and those charged with governance of identified control deficiencies that are significant deficiencies or material weaknesses in internal control. The intent of the Auditing Standards Board in issuing SAS 112 was to raise the bar when it comes to defining "good internal controls". As a result we expect more organizations will report significant control deficiencies to their governing board.

During our audit, we noted the following areas of the Santa Clara Valley Health & Hospital System Enterprise Fund (SCVHSEF) that should be evaluated prior to the 2006/07 audit to ensure that controls over financial statements are adequate.

- Timely recording of non-routine transactions such as new debt issuances and capital assets transfers to the stand-alone accounting system.
- Proper succession planning of critical accounting and finance functions within the SCVHSEF.

We recommend that the County timely record non-routine transactions in the stand-alone accounting system. In addition, the SCVHSEF should evaluate its current staff composition to ensure that it has a strong foundation for continuity in its critical accounting and finance functions.

Management Response:

The comment above refers to several transactions that were recorded late, primarily due to staffing changes. However, management does not think that these instances are indicative of a trend or that they will recur.

Succession planning is an ongoing challenge and priority throughout the County. In the specific case of SCVHSEF Finance, management has worked with ESA over the last two years to create positions that will strengthen the foundation of its critical accounting and finance functions. SCVHSEF Finance will continue to look for opportunities to enhance succession planning and continue to capitalize on them when they do arise.

Workers' Compensation Deficit Fund Balance

The County's Worker's Compensation Fund (Fund) is classified as an internal service fund and has an increasing deficit net assets balance. At June 30, 2006, the Fund has a fund deficit in the amount of $40.1 million. Although the rate of the current year's deficit slowed to 0.7%, or $0.3 million when compared to the prior year's 41.5%, the County still continues to experience an increase in its deficit. The financial statement impact of this situation is that the Fund is financing its past services and has subsidized the operations of several of the County's funds. It is therefore not acting as an internal service fund whereby the revenues earned are enough to cover its operating expenses, but more a fund operating on a cash basis whereby the cash received from the other departments are enough to cover its current cash outflows.
Workers' Compensation Deficit Fund Balance (Continued)

Our review of the County's actuarial study of the County's self-insured workers' compensation program noted that the County's policy is to fund the workers' compensation liabilities at the discounted expected confidence level and the study was based on this assumption. However, the County budgeted to fund the 2006/07 fiscal year workers' compensation program on a pay-as-you-go (cash basis). As a result, the County is not projected to significantly reduce this deficit in the upcoming year.

We recommend that if the County does not start to fund the workers' compensation program at the discounted expected confidence level, the County consider steps to discontinue using an internal service fund to account for its workers' compensation program and record this activity in its General Fund.

Management Response:

In order to balance FY05 budget, the County temporarily deviated from its funding policy from 100% of liabilities at 50% confidence level to 50% of liabilities at 50% confidence level. The total County contribution to the program of about $11M attained that goal (50% at 50% confidence level), which increased the unfunded liabilities from $28M to $40M at the end of FY05.

In FY06, the County again changed its contribution to equal the estimated payout (actual cost of claims plus overhead) in order to keep the assets ($35.2M) intact and maintain the unfunded liability. The total County contribution of $28M, although more than doubled that of FY05, increased the assets to $36.1M but slightly increased the unfunded liability by $0.3M at the end of FY06. The County has maintained the contribution to equal the estimated payout in FY07 and will look into recovering the deficit (or part of it) in FY08 or when budget permits.
STATUS OF PRIOR YEAR COMMENTS

Comment:

Timeliness of the Sanitation District Audit

We recommend the Sanitation District place emphasis on the importance of completing its audit in a timely manner and plan to have its audited financial statements available to the County by the end of September. Timely completion of the Sanitation District's financial statement audit will enable the County to meet its CAFR timelines.

Implemented.

Workers' Compensation Deficit Fund Balance

We recommend that if the County continues to use an internal service fund, then the County's Workers' Compensation Fund should: (i) set its rates realistically to at least cover the cost of the services it provides and (ii) set the rates to recover the current net assets deficit. Otherwise, the more appropriate classification of a "pay-as-you-go" activity would be the General Fund.

Not implemented. See comment noted in previous page.