COUNTY OF SANTA CLARA

Report to the Finance and Government Operations Committee

Year Ended June 30, 2011
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Year Ended June 30, 2011

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Finance and Government Operations Committee
County of Santa Clara
San Jose, California

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate discretely presented component units and remaining fund information of the County of Santa Clara, California, (the County), as of and for the year ended June 30, 2011, and have issued our report thereon dated February 7, 2012. Our opinions on the financial statements and this report, insofar as they relate to the certain discrete component units (collective, “Affiliates”) of the Housing Authority of the County of Santa Clara (“Housing Authority”), the FIRST 5 Santa Clara County; the County Sanitation District 2 – 3 of Santa Clara County; the Santa Clara County Vector Control District; the Silicon Valley Tobacco Securitization Authority; the Santa Clara County Tobacco Securitization Corporation; and the Santa Clara County Central Fire Protection District, the South Santa Clara County Fire District, and the Los Altos Hills County Fire District (collectively, “Fire Districts”), are based solely on the reports of other auditors.

Management of the County is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit of the County’s basic financial statements in accordance with auditing standards generally accepted in the United States of America, we considered the County’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 County’s internal control. Accordingly, we do not express an opinion on the effectiveness of the County’s internal control over financial reporting.

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 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.

Our consideration of internal control over financial reporting 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, there can be no assurance that all such deficiencies have been identified. We did not identify any deficiencies in internal control over financial reporting that we considered to be material weaknesses.

The County’s written response to the finding identified in our audit is described in the Current Year Recommendation section. We did not audit the County’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 these matters, or to assist you in implementing this recommendation.
Professional auditing standards require that we provide you with information about our responsibilities under generally accepted auditing standards, *Government Auditing Standards* and U.S. Office of Management and Budget (OMB) Circular A-133, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our General Audit Plan dated August 16, 2011. Professional standards also require that we communicate to you other information related to our audit as discussed on pages 1 through 4. We have also provided a status of our prior years recommendations. We would like to thank County management and staff for the courtesy and cooperation extended to us during the course of our engagement.

This communication is intended solely for the information and use of the Finance and Government Operations Committee, Board of Supervisors, 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.

Macias Gablett, LLP
Walnut Creek, California
February 7, 2012
REQUIRED COMMUNICATIONS

I. Other Information in Documents Containing Audited Financial Statements

During the year, the County included its audited basic financial statements in various debt offering documents (e.g., Official Statements). We do not have an obligation to perform any procedures to corroborate other information contained in such debt offering documents. We were not associated with and did not have any involvement with such documents. Accordingly, we did not perform any procedures on these documents and provide no assurance as to the other information contained in the debt offering documents.

With respect to the supplementary information accompanying the financial statements, 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 supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

II. Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management is responsible for the 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. With the exception of the items described below, no new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2011.

- As discussed in Note 1(o) to the financial statements, the County adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 54, Accounting and Financial Reporting for Fund Balance Reporting and Governmental Fund Type Definitions.

- As discussed in Note 1(a) to the financial statements, during the fiscal year, the GASB issued guidance related to the treatment of housing authorities as general partners of limited tax credit partnerships whereby limited partners have limited rights regarding the operations of the partnership and the housing authority possesses essentially all authority over day-to-day operations. Prior to this guidance, the Housing Authority has discretely presented the financial position and results of operations of the general partners’ interests. After evaluating the recent guidance, the Housing Authority decided to restate the beginning net assets of its component units in the amount of $50.8 million to include the limited partners’ interests.

We noted no transactions entered into by the County during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.
REQUIRED COMMUNICATIONS (Continued)

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 are as follows:

- Fair value of investments
- Estimated valuation allowance for losses on accounts and loans receivable
- Estimated valuations on donated capital assets
- 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
- Accrual and disclosure of self insured claims liabilities
- Accrual and disclosure of compensated absences
- Pension and other postemployment benefit plans’ employer and employee contribution requirements
- Amortization estimates for net pension asset including amortization methods
- Accrual and disclosure of pollution remediation obligations

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

- Fair values of investments were based on quoted market prices.
- Estimated valuation allowance for losses on accounts receivable were based on historical experience and loans receivable was based on the type of loan and management’s estimate regarding the likelihood of collectibility based on loan provisions and collateral.
- Estimated valuations on donated capital assets were based on its estimated fair market value on the date donated.
- Useful lives for depreciable property were determined by management based on the nature of the capital asset.
- Estimated contractual adjustments and cost report settlements receivable and payables were based on prior cost report adjustments, previous regulatory settlements, and the potential future retrospective adjustments based on current laws and regulations.
- Estimated bad debt allowances for patient accounts receivable were based on historical experience.
- The liability for automobile liability, general liability, medical malpractice, and workers’ compensation claims were based on actuarial evaluations using historical loss and other data.
- The liability for other claims was determined by attorney judgment about the ultimate outcome of the claim.
- Accrual and disclosure of compensated absences were based on accrued eligible hours of vacation at current pay rates for eligible employees.
- Pension and other postemployment benefit plans’ employer and employee contribution requirements were based on actuarially determined contribution rates.
REQUIRED COMMUNICATIONS (Continued)

- Amortization estimates for net pension asset were based on actuarially determined factors.
- Accrual of pollution remediation obligations are based on reports from independent consultants.

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 County’s basic financial statements.

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were the disclosure of employee benefit plans in Note 12 to the financial statements related to the County’s pension and other post employment benefit plans and the disclosure of pollution remediation in Note 15 to the financial statements related to the Almaden Quicksilver County Park.

Difficulties Encountered in Performing the Audit

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

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. During our audit, we detected a material misstatement as a result of our audit procedures related the County’s changes in its process for the recording of trust fund activities which resulted in the “gross-up” of an asset (due from other governmental agencies) and a liability (unearned revenues) totaling $59.4 million as discussed as part of Comment #2011-A. Management has corrected this misstatement. The attached Summary of Uncorrected Financial Statement Misstatements summarizes uncorrected misstatements of the financial statements. Management has determined that their effects are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, 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.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated February 7, 2012.
REQUIRED COMMUNICATIONS (Continued)

Management 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.

Other Audit Finding or Issues

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.
CURRENT YEAR RECOMMENDATION

Control Deficiency #1 – Item 2011-A - Improve Internal Controls Over Financial Reporting

The Office of Management and Budget defines internal control as the steps an agency takes to provide reasonable assurance that the agency’s objectives are achieved through 1) effective and efficient operations, 2) reliable financial reporting, and 3) compliance with laws and regulations. Over the years, the County has established an internal control assessment process, documented its controls for significant accounts and transactions; and evaluated the effectiveness of its internal control over financial reporting.

Internal controls should be continuously assessed and evaluated in order to adapt to the County’s changes in its controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements; controls related to the initiation and processing of non-routine and non-systematic transactions; and controls related to the selection and application of appropriate accounting policies.

During the fiscal year 2011 audit of the County’s basic financial statements, we noted the following:

- Changes in its process for the recording of trust fund activities which resulted in the “gross-up” of an asset (due from other governmental agencies) and a liability (unearned revenues) totaling $59.4 million which was subsequently discovered and adjusted by the County.
- The County completed its development of the Tax Collection and Apportionment System (TCAS). TCAS is the County’s integrated system that will automate the calculation, collection and distribution of tax revenues which would change a myriad of the County’s internal processes and reporting capabilities.
- The County engaged a new firm to update its other postemployment benefits plan actuarial study incorporating a lower discount rate due to the County’s change in its funding policy. This update required additional time by staff to evaluate and review the current and future impact of the actuarial assumption changes on its financial reports and its funding plans.
- During the fiscal year, the County issued Teeter Plan Obligation Commercial Paper notes which required additional staff time to evaluate the proper accounting and reporting treatment of this new type of debt issuance for the County.

In addition to these changes noted above, in fiscal year 2012 the County will face additional responsibilities related to the dissolution of nine redevelopment agencies located throughout the County.

As the County goes through changes, it needs to continue to re-evaluate its internal control over financial reporting and monitor the effect of these changes to ensure that the procedures are designed appropriately and are operating effectively.

Management Response:

The County will continue to strengthen its internal control over financial reporting to ensure effective procedures are designed appropriately and are operating effectively.
STATUS OF PRIOR YEAR RECOMMENDATIONS

Comment: FY 2010-A  

**Workers’ Compensation Fund Deficit Net Assets Balance**

**Condition/Effect:** During our audit, we noted that the County has not set user fees to recover the full cost of disability, medical, and rehabilitation expenses and related costs. At June 30, 2010, the Fund has deficit net assets balance in the amount of $29.3 million, an increase of $0.9 million when compared to prior year’s deficit of $28.4 million. 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 like a fund operating on a cash basis whereby the cash received from the other departments are enough to cover its current cash outflows.

**Recommendation:** We recommend the County evaluate its ability to fund its workers’ compensation program on an accrual basis within a reasonable period of time to determine whether or not to discontinue the use of an internal service fund.

**Status:** In progress. At June 30, 2011, the Fund has a deficit net assets balance in the amount of $33.7 million, an increase of $4.4 million when compared to prior year’s deficit of $29.3 million. The County is planning to increase its charges rate to other funds to cure the deficit net assets balance starting fiscal year 2014.

Comment: FY 2010-B  

**Other Postemployment Benefit Funding**

**Condition/Effect:** In determining the County’s Other Postemployment Benefits (OPEB) annual required contribution (ARC) for the fiscal year, the County obtained an actuarial valuation dated June 30, 2009. The ARC is the County’s annual required contributions to its Other Postemployment Benefit Plan (Plan) calculated in accordance with a set of parameters defined by the Governmental Accounting Standards Board (GASB). One of the key elements to the calculation of ARC is the County’s funding policy and the related investment rate of return assumption. The County’s actuarial valuation dated June 30, 2009, assumed that the County would be fully funding its annual ARC through fiscal year 2012, which allowed the County to assume a higher rate of return reflecting its plan assets investment portfolio’s estimated rate of return of 7.75% per annum.
STATUS OF PRIOR YEAR RECOMMENDATIONS

Recommendation: We recommend the County update its actuarial valuations and evaluate its expected long-term future trends and evaluate each assumption for reasonableness and consistency with its policies and future strategic plans in order to provide a more accurate picture of its OPEB costs and obligations.

Status: Completed.

Comment: FY 2010-C

Fund Balance Reporting and Governmental Fund Type Definition

Condition/Effect: In February 2009, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions. GASB 54 significantly changes the accounting and financial reporting for the County’s fund balance classifications and categorization of individual funds. Under previous standards, the County’s governmental fund balances were organized into three categories: reserved, unreserved, and designated. The new standard replaces these with five classifications, establishing a hierarchy that is based on the extent to which spending constraints restrict how a government can use the funds.

Recommendation: Some steps that the County should perform in order to implement GASB Statement No. 54 include the following:

- Update the County’s fund balance policy.
- Analyze the purposes and revenue sources of the County’s special revenue funds to ensure that these funds fall within the new special revenue fund type definition.
- Review the purposes of capital projects and debt service funds to ensure that these funds fall within the new fund type definitions.
- Update chart of accounts and begin classifying fund balance amounts and prepare reports for the new financial reporting and disclosure requirements.

Status: Completed.
COUNTY OF SANTA CLARA
Report to Finance and Government Operations Committee
Year Ended June 30, 2011

SUMMARY OF UNCORRECTED FINANCIAL STATEMENTS MISSTATEMENTS

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<thead>
<tr>
<th>Adjustment Description</th>
<th>(In thousands)</th>
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<tr>
<td></td>
<td>Debit</td>
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<tr>
<td><strong>Current Year PAJE #1</strong></td>
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<tr>
<td>Fixed Assets - Construction in Progress</td>
<td>$4,008</td>
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<tr>
<td>Accounts Payable</td>
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</tr>
<tr>
<td>(Santa Clara Valley Medical Center Enterprise Fund / Government-wide Business-Type Activities - To accrue for capital expenses incurred in FY11 but not accrued at June 30, 2011.)</td>
<td></td>
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| **Current Year PAJE #2** |       |        |
| Purchased Service Expenses | $5,198 | $5,198 |
| Accounts Payable           |        |        |
| (Santa Clara Valley Medical Center Enterprise Fund / Government-wide Business-Type Activities - To accrue for expenses incurred in FY11 but not accrued at June 30, 2011.) | |