Grant Thornton

2019 Audit Wrap Up Presentation and Discussion

City of San José

-- DRAFT --

Federated City Employees' Retirement System; and
Police and Fire Department Retirement Plan
(collectively, “the Plans”)

Audits for the year ended June 30, 2019

October 17, 2019

Our Values are CLEARR

To achieve our global vision, we capitalize on our strengths by embracing the following values:

- Unite through global **Collaboration**
- Demonstrate **Leadership** in all we do
- Promote a consistent culture of **Excellence**
- Act with **Agility**
- Ensure deep **Respect** for people
- Take **Responsibility** for our actions

Our values serve as the foundation of each step we take toward achieving our vision. They guide our decision-making and provide a framework for our people to make correct and appropriate choices.

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Audit Timeline & Scope

January 2019	Client continuance	• Discuss with management any major changes in FY2019 • Issue engagement letter • Developed PBC list, project timelines, etc.
April – May 2019	Planning	• Held planning meetings with management to further discuss the timing to fieldwork and considerations for the audits • Presented audit plan to the Joint Audit Committee on May 16
May 2019	Preliminary risk assessment procedures	• Develop audit plan that addresses risk areas • Assessed financial reporting risk related to the Plans
May – July 2019	Interim fieldwork	• Perform walk-throughs of business processes and controls • Performed interim testing on contributions, eligibility, benefit payments and census data • Performed interim testing on investment purchases and sales
August – October 2019	Final fieldwork	• Performed testing on investments portfolios including fair value • Performed remaining testing on contributions, eligibility, benefit payments and census data • Reviewed financial statements
November 2019	Final deliverables	• Issued opinion and other communications

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Significant Risks

The following provides an overview of the areas of significant audit focus based on our risk assessments.

Areas of focus	Results
Fair value measurements of investments and related disclosures	• Confirmed investments held by the Plans with State Street as of year end. • Tested fair values at the end of the year. • Performed analytics on investment income • Reviewed fair value measurement disclosures. • Reviewed SSAE 16 report for State Street as well as management's complementary user controls. • Reviewed management's process for assessing fair value provided by investment manager's and the custodian • No significant issues noted

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Significant Risks (continued)

The following provides an overview of the areas of significant audit focus based on our risk assessments.

Areas of focus	Results
Actuarial amounts not determined properly	• Obtained census data and compared to the data maintained by management. • Performed testing around census data movement. • Engaged our Human Capital Resources Group to review the Cheiron actuarial valuation report and evaluate the underlying assumptions for reasonableness for both the defined benefit pension and OPEB plans • No significant issues noted.

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Significant Risks (continued)

The following provides an overview of the areas of significant audit focus based on our risk assessments.

Areas of focus	Results
Benefits payments improperly computed	• Tested eligibility requirements for the benefit payments • Recalculated the related distributions to ensure they were allowable per the municipal code and that the amounts distributed were accurate. • No significant issues noted
Fraud related to journal entries • Auditing standards suggest that an auditor's identification of fraud risks should include the risk of management override of controls	• Made inquiries of management. • Made inquiries of State Street (the "Custodian") representative • Obtained an understanding of management's process relating to Plans' financial reporting. • Sample tested journal entries based on specific criteria. Entire ledger was analyzed using an automated tool. • No significant issues noted.

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Other Key Areas

The following provides an overview of the other key areas of audit focus based on our risk assessments.

Areas of focus	Results
Participant data and eligibility	• Selected a sample of participants and tested for eligibility and recalculated contributions (both employee and employer). • Selected a sample of remittances during the year and agreed them to transmittal support to the custodian. • Chose three employees and tested for proper exclusion. • No significant issues noted.
Financial statement presentation and disclosure	• Verified disclosures related any newly implemented GASB Statements were included • No significant issues noted.

Summary of Misstatements – the System

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Description	Assets	Liabilities	Equity	Net Income
	Increase (Decrease) to:			
Material, corrected misstatements				
None noted.				
Net impact	$ -	$ -	$ -	$ -
Uncorrected misstatements				
Net appreciation in FV				7,000,525
Investments	7,000,525			
To adjust for fair value of NAV investments from Confirmation procedures as of 6/30/19				
Net depreciation in FV				(989,189)
Investments	(989,189)			
To adjust for fair value of Level 3 investments from Confirmation procedures as of 6/30/19				
Net impact	$ 6,011,336	$ -	$ -	$ 6,011,336

Disclosure misstatements

Material, corrected

- None noted as of 10/17/2019

Uncorrected

- None noted as of 10/17/2019

Management believes the uncorrected misstatements are immaterial to the financial statements. Uncorrected misstatements could be potentially material to future financial statements. As such, we request that these uncorrected misstatements be corrected.

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Summary of Misstatements – the P&F Plan
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Description	Assets	Liabilities	Net Assets	Net Income
	Increase (Decrease) to:			
Material, corrected misstatements				
Accrued Investment Sold-Police HCT	(513,851)			
Accrued Investment Purchases-Fire HCT		(513,851)		
To adjust accrued investment allocation				
Net impact	$ (513,851)	$ (513,851)	$ -	$ -
Uncorrected misstatements				
Net appreciation in FV				13,511,097
Investments	13,511,097			
To adjust the fair value of NAV investments from Confirmation procedures as of 6/30/19				
Net appreciation in FV				4,912,478
Investments	4,912,478			
To adjust the fair value of Level 1 investments from Confirmation procedures as of 6/30/19				
Net appreciation in FV				8,461,585
Investments	8,461,585			
To adjust error in fair value of Hudson Bay NAV investment as of 6/30/19				
Net impact	$ 26,885,160	$ -	$ -	$ 26,885,160

Disclosure misstatements

Material, corrected

- None noted as of 10/17/2019.

Uncorrected

- None noted as of 10/17/2019.

Management believes the uncorrected misstatements are immaterial to the financial statements. Uncorrected misstatements could be potentially material to future financial statements. As such, we request that these uncorrected misstatements be corrected.

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Disclosure Adjustments – the System

Recorded disclosure adjustments

The following is a description of adjustments to disclosures identified during the audit that were made by the Plans:

- None noted.

Unrecorded disclosure adjustments

The following is a description of omitted, incomplete or inaccurate disclosures identified during the audit that were not made by the Plans:

1. Levelling – Consistent with the fact pattern noted in the prior year audit, there continues to exist a private debt investment of $5,165,811 that has been disclosed as Level 2. There is insufficient support for the management designation as a level 2 investment. Based upon the available support, these security types should be classified as level 3.

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Disclosure Adjustments – the Plan

Recorded disclosure adjustments

The following is a description of adjustments to disclosures identified during the audit that were made by the Plans:

- None noted.

Unrecorded disclosure adjustments

The following is a description of omitted, incomplete or inaccurate disclosures identified during the audit that were not made by the Plans:

1. Levelling Consistent with the fact pattern noted in the prior year audit, there continues to exist a private debt investment of $10,331,621 that has been disclosed as Level 2. There is insufficient support for the management designation as a level 2 investment. Based upon the available support, these security types should be classified as level 3.

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Other Required Communications

Professional standards require that we communicate the following matters to you, as applicable.

Going concern matters – ***No issues noted***
Fraud and noncompliance with laws and regulations – ***No issues noted***
Significant deficiencies and material weaknesses in internal control over financial reporting – ***See following slides***
Use of other auditors – ***Not applicable***
Use of internal audit – ***No issues noted***
Related parties and related party transactions – ***City of San Jose***

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Other Required Communications
(continued)

Disagreements with management – ***No issues noted***
Management's consultations with other accountants – ***No issues noted***
Significant issues discussed with management – ***No issues noted***
Significant difficulties encountered during the audit – ***No issues noted***
Other significant findings or issues that are relevant to you and your oversight responsibilities – ***See following slides***
Modifications to the auditor's report – ***None***
Other information in documents containing audited financial statements – ***Required supplementary Information and Other supplementary information reviewed as part of the holistic CAFR financial statements review process.***

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Quality of Accounting Practices

Accounting policies	• The significant accounting policies used by the Plans are disclosed in the notes to the financial statements. • Accounting policies and their application were appropriate and consistently applied. • There were no changes in significant accounting policies. • There were no accounting policies unique to the industry. • We noted no significant unusual transactions, or other significant transactions in controversial or emerging areas of which there is a lack of authoritative accounting guidance or consensus. • There were no effects of the timing of transactions in relation to the period in which they are recorded.

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Quality of Accounting Practices

Accounting estimates

Fair value measurement

The Plans' assets are held by State Street and management relies on State Street reports (quarterly and annually) as well as the various investment managers’ reports in determining fair value of the Plans' investments.

Management has assessed the valuation techniques employed by State Street and the investment managers and determined them to be in accordance with GASB Statement No. 72.

Grant Thornton's comments are addressed in the report on internal control.

Actuarial assumptions

Management makes significant estimates related to the actuarial valuations of the Plans. These valuations are completed by Cheiron and reviewed by management. There are inherent complexities surrounding the inputs, methods, and assumptions to the actuarial valuations of the Plans.

Management has assessed the methods and assumptions employed by Cheiron in the valuation of the pension and OPEB reports and determined them to be in accordance with GASB Statements No. 67/68 and 74/75.

Quality of Accounting Practices

Disclosures	• We noted completeness of financial statements and disclosures. • We noted overall neutrality and consistency.
Other Related Matters	• None Noted

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Internal Controls Matters

Responsibility We are responsible for obtaining reasonable assurance about whether the financial statements are free of material misstatement. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control. Accordingly, we express no such opinion. Control deficiencies that are of a lesser magnitude than a significant deficiency will be communicated to management.

Definitions

- A deficiency in internal control ("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 deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.
- 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 company's annual or interim financial statements will not be prevented or detected on a timely basis.

Internal Controls Matters

Our consideration of internal control was not designed to identify all deficiencies in internal control that, individually or in combination, might be material weaknesses. Therefore, material weaknesses may exist that were not identified.

Our findings are communicated to you in our draft letter dated November 5, 2019 (open for finalization) for the Plan and the System, respectively.

Control deficiencies that are of a lesser magnitude than a significant deficiency will be or have been communicated to management.

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The Company's response has not been subjected to our audit procedures and, accordingly, we express no opinion on it.

Open items as of October [17], 2019

The following items remain open for completion as of October [17], 2019:

Deliverable	Expected date - Federated	Expected date – Police & Fire
Audit Committee presentation	October 17, 2019	October 17, 2019
Management Representation letter	November 5, 2019	November 5, 2019
Issuance of Internal control report and summary of findings and deficiencies	November 5, 2019	November 5, 2019
Issuance of Audit Report	November 5, 2019	November 5, 2019

Other area's of the audit:

1. Completion of Investment's testing: NAV Testing and internal review process
2. Receipt of legal letter
3. Internal review process of actuarial assumptions
4. Completion of detail tie-out of CAFR
5. Review of the City CAFR

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Audit Wrap Up Presentation

Technical Updates – GASB

GASB Statement 87, *Leases*

Summary

- The GASB recently issued guidance which resembles the recently issued FASB guidance on leases.
- To determine whether a lease exists, a government should assess whether it has both:
  1) The right to obtain the present service capacity from use of the underlying asset as specified in the contract, and
  2) The right to determine the nature and manner of use of the underlying asset as specified in the contract
- For Lessees:
  - In general, all leases will be reported on the statement of net position (the distinction between operating and capital leases is no longer relevant) as a "right of use" intangible asset and a corresponding lease liability within long term debt
  - On the statement of changes, rent expense will be replaced by amortization expense of the right-of-use asset as well as interest expense on the lease liability (thus accelerating expenses in the beginning years of the lease term)
  - There is an exemption for short term leases (those with a term of 12 months or less, including extension options) as well as leases that transfer ownership at the end of the term
  - Disclosures regarding matters such as total leased assets by major class of underlying assets and related accumulated amortization (in total), principal and interest payments for each of the five subsequent fiscal years and in five year increments thereafter and commitments under leases before a lease commencement period, among other items

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GASB Statement 87, *Leases (continued)*

Summary, continued

- For Lessors:
  - Record a lease receivable and a deferred inflow of resources equal to the present value of future lease payments (which should generally equal the amount recorded as a liability by the lessee), and also continue to report the leased asset
  - The receivable will be reduce as cash is received, the asset will be depreciated (generally) and the deferred inflow will be recognized over the lease term
  - Disclosures regarding matters such as general description of leasing arrangements, total amount of inflows of resources, and those related to variable payments, residual guarantees, etc., and the existence, terms and conditions of options by the lessee to terminate the lease or abate payments in certain circumstances, among other disclosures
- Effective for periods beginning after December 15, 2019, with early adoption encouraged. Existing leases will be adjusted based on the remaining lease payments as of the beginning of the period of adoption or beginning of any earlier periods restated (for example, for June 30 year ends, adoption is June 30, 2021 so the beginning period is July 1, 2020).

Potential Impact

For entities which use operating leases to finance certain capital activities, this standard could have a significant impact on the financial statements upon adoption. Management should undertake a complete inventory of existing leases that would be subject to the new accounting and disclosures.

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GASB projects

Project	Timing
Financial Reporting Model- Reexamination of Statements 34, 35, 37, 41 and 46, and Interpretation 6	Preliminary Views to issued in September 2018, planned issuance of final standard in 2022.
Revenue and expense recognition	Preliminary Views expected in May 2020 (currently in redeliberations)

GASB major project – Financial Reporting Model

Summary

- GASB is revisiting its reporting model established in GASB 34 and 35, as well as other GASB standards, following the FASB project to revisit the reporting model of NFP entities.
- Although there is general consensus that most of the components of the financial reporting model are effective, the Board determined that there is a need to update guidance related to several categories, focusing on the following:
  - MD&A
  - Government-wide financial statements
  - Major funds
  - Governmental fund financial statements
  - Proprietary fund and business-type activity financial statements
  - Fiduciary fund financial statements
  - Budgetary comparisons
- Tentative Preliminary Views of note for colleges and universities (Preliminary Views to be issued in September 2018):
  - Definition of non-operating activities includes i) subsidies received and provided, ii) revenues and expenses of financing, iii) resources from the disposal of capital assets and inventory and iv) investment income and expenses
  - A subtotal for "operating income/(loss) and noncapital subsidies"
  - Government-wide schedule of natural classification of expenses would be presented as supplementary information (BTA activities by segment)

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GASB major project – Financial Reporting Model, continued

Potential impact
Similar to the significant impact on reporting and disclosures when GASB 34 and 35 were issued, this proposed guidance could have sweeping effects on the reporting and disclosures by the plans. Depending on how much the GASB looks to what was done by the FASB on the NFP reporting model, there could be an increase in comparability between the two types of entities that currently use very different reporting models. Three of the business type activities issues that the GASB is considering that are particularly relevant to public universities are guidance on the operating indicator, MD&A and extraordinary and special items. Based on comments made by GASB representatives, one of the tentative preliminary views is to present a subtotal for "operating income/loss and noncapital subsidies", which includes state appropriations. This is an accommodation to the request by many constituents to include state appropriations as an operating revenue, which will not be changed based on tentative preliminary views. In addition, the addition of a separate schedule of expenses by natural classification will highlight certain expenses that may receive additional scrutiny such as salary/compensation expense. Depending on the ultimate guidance, universities may want to think about how the reporting of these expenses will be captured to be accurately reported in the financial statements.

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GASB pre-agenda research

Topics
- Going concern disclosures - Note disclosures reexamination - Deferred compensation plans, reexamination of Statement 32

Commitment to Promote Ethical and Professional Excellence

We are committed to promoting ethical and professional excellence. To advance this commitment, we have put in place a phone and internet-based hotline system.

The Ethics Hotline (1.866.739.4134) provides individuals a means to call and report ethical concerns.

The EthicsPoint URL link can be accessed from our external website or through this link:
https://secure.ethicspoint.com/domain/en/report_custom.asp?clientid=15191

Disclaimer: EthicsPoint is not intended to act as a substitute for a company's "whistleblower" obligations.