SANTA CLARA COUNTY CITIES ASSOCIATION

Independent Auditor's Report and
Basic Financial Statements

For the Years Ended June 30,
2007, 2006, 2005, 2004 and 2003

MGO

MACIAS GINI & O'CONNELL LLP

CERTIFIED PUBLIC ACCOUNTANTS & MANAGEMENT CONSULTANTS

SANTA CLARA COUNTY CITIES ASSOCIATION
FOR THE YEARS ENDED
JUNE 30, 2007, 2006, 2005, 2004 AND 2003

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Board of Directors
Santa Clara County Cities Association
Sunnyvale, California

INDEPENDENT AUDITOR'S REPORT

We have audited the accompanying basic financial statements of the Santa Clara County Cities Association (Association) as of and for the years ended June 30, 2003, 2004, 2005, 2006 and 2007 as listed in the table of contents. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Association's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Association as of June 30, 2003, 2004, 2005, 2006 and 2007, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the basic financial statements, the Association adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments,* GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus* and GASB Statement No. 40, *Deposit and Investment Risk Disclosures—an amendment of GASB Statement No. 3.*

The Association has not presented the management's discussion and analysis that accounting principles generally accepted in the United States of America has determined as necessary to supplement, although not required to be part of, the basic financial statements.

Macias Gini & O'Connell LLP
Certified Public Accountants

Walnut Creek, California
March 28, 2008

SANTA CLARA COUNTY CITIES ASSOCIATION
STATEMENTS OF NET ASSETS
JUNE 30, 2007, 2006, 2005, 2004, AND 2003

	2007	2006	2005	2004	2003
Assets					
Cash and cash equivalents	$ 61,130	$ 41,339	$ 48,412	$ 57,230	$ 61,801
Interest receivable	196	196	196	196	233
Prepaid rent and deposits	400	400	620	620	620
Depreciable capital assets, net	1,091	1,513	1,935	-	-
Total assets	62,817	43,448	51,163	58,046	62,654
Liabilities					
Accrued expenses	-	-	2,111	-	-
Unearned revenue	7,345	-	-	-	-
Total liabilities	7,345	-	2,111	-	-
Net Assets:					
Invested in capital assets	1,091	1,513	1,935	-	-
Unrestricted	54,381	41,935	47,117	58,046	62,654
Total net assets	$ 55,472	$ 43,448	$ 49,052	$ 58,046	$ 62,654

See accompanying notes to the financial statements.

SANTA CLARA COUNTY CITIES ASSOCIATION
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN FUND NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2007, 2006, 2005, 2004 AND 2003

	2007	2006	2005	2004	2003
Operating Revenues					
Dues	$ 83,682	$ 76,072	$ 72,450	$ 69,000	$ 69,000
Other	-	-	-	140	-
Total operating revenues	83,682	76,072	72,450	69,140	69,000
Operating Expenses					
Salaries and benefits	67,685	69,838	61,115	56,053	50,771
Other professional services	-	900	1,950	1,825	1,120
Payroll processing expenses	688	694	890	994	968
Bank service charges	39	36	46	63	47
Conference/director's expenses	1,428	545	1,060	873	416
Depreciation	422	422	176	-	-
Dues and subscriptions	160	438	450	513	412
Hospitality	358	825	891	1,361	1,079
Internet service	424	275	437	627	633
Insurance	-	-	568	1,205	204
Maintenance and repairs	-	179	439	264	198
Office supplies	371	644	774	1,556	1,257
Postage and delivery	230	182	353	883	1,237
Printing and copying	-	340	597	461	311
Project and workshop support	-	1,250	1,450	397	500
Recognition	175	391	489	497	753
Rent	4,830	4,800	5,240	5,430	5,280
Property taxes	93	-	91	-	-
Telephone	865	1,086	1,068	600	902
Travel	-	313	720	450	594
Total operating expenses	77,768	83,158	78,804	74,052	66,682
Operating income (loss)	5,914	(7,086)	(6,354)	(4,912)	2,318
Nonoperating revenues (expenses)					
Interest income	3,772	2,134	1,143	1,018	1,482
Membership dinners:					
Dinner collections	7,565	6,322	6,853	7,189	8,952
Dinner costs	(5,783)	(6,453)	(9,739)	(7,338)	(5,962)
Total membership dinners, net	1,782	(131)	(2,886)	(149)	2,990
Directories:					
Directory income	1,327	742	481	787	794
Directory production costs	(771)	(1,263)	(1,378)	(1,352)	(1,394)
Total directory, net	556	(521)	(897)	(565)	(600)
Net nonoperating income (loss)	6,110	1,482	(2,640)	304	3,872
Change in net assets	12,024	(5,604)	(8,994)	(4,608)	6,190
Net assets, beginning of year	43,448	49,052	58,046	62,654	56,464
Net assets, end of year	$ 55,472	$ 43,448	$ 49,052	$ 58,046	$ 62,654

See accompanying notes to the financial statements.

SANTA CLARA COUNY CITIES ASSOCIATION
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2007, 2006, 2005, 2004 AND 2003

	2007	2006	2005	2004	2003
Cash flows from operating activities:					
Dues from members	$ 91,027	$ 76,072	$ 72,450	$ 69,000	$ 69,000
Payments for supplies	(9,661)	(14,789)	(15,402)	(17,999)	(17,053)
Payments to employees	(67,685)	(69,838)	(61,115)	(56,053)	(50,771)
Others receipts	8,892	7,064	7,334	8,116	9,746
Others payments	(6,554)	(7,716)	(11,117)	(8,690)	(7,356)
Net cash provided (used) by operating activities	16,019	(9,207)	(7,850)	(5,626)	3,566
Cash flows from capital and related financing activities					
Acquisition of capital assets	-	-	(2,111)	-	-
Cash flows from investing activities					
Interest on investments	3,772	2,134	1,143	1,055	1,626
Net change in cash and cash equivalents	19,791	(7,073)	(8,818)	(4,571)	5,192
Cash and cash equivalents, beginning of year	41,339	48,412	57,230	61,801	56,609
Cash and cash equivalents, end of year	$ 61,130	$ 41,339	$ 48,412	$ 57,230	$ 61,801
Reconciliation of operating income (loss) to net cash provided (used) by operating activities:					
Operating income (loss)	$ 5,914	$ (7,086)	$ (6,354)	$ (4,912)	$ 2,318
Adjustments to reconcile operating income (loss) to net cash provided (used) by operating activities:					
Depreciation	422	422	176	-	-
Nonoperating revenues	8,892	7,064	7,334	7,976	9,746
Nonoperating expenses	(6,554)	(7,716)	(11,117)	(8,690)	(7,356)
Changes in:					
Prepaid rent and deposits	-	220	-	-	-
Accrued expenses	-	(2,111)	2,111	-	(1,142)
Unearned revenue	7,345	-	-	-	-
Net cash provided (used) by operating activities	$ 16,019	$ (9,207)	$ (7,850)	$ (5,626)	$ 3,566

See accompanying notes to the financial statements.

NOTE 1 – **SIGNIFICANT ACCOUNTING POLICIES**

Reporting Entity

The Santa Clara County Cities Association (Association), an unincorporated association, was established in February 1990 by the cities of Santa Clara County, California. The association is a joint powers agreement among the member cities and is not a public entity separate from the parties to the agreement. The purpose and functions of the Association are (a) to review, study, develop consensus positions, and recommend on issues of interest to the Santa Clara County cities; (b) to develop a common agenda for the Santa Clara County cities; (c) to serve as a unified voice for Santa Clara County cities in relationship to other agencies, organizations, and levels of government, including the Peninsula Division of the League of California Cities; (d) to serve as the City Selection Committee pursuant to Government Code, Section 50270 et seq., and make appointments to regional and local bodies as provided by law; (e) to assist in development of statewide legislative policy through the structure of the League of California Cities; (f) to serve as a source of education, information and networking for officials from all cities in Santa Clara County; and (g) to provide a forum for non-city individuals, groups and organizations, and the private sector to address items of interest to the Santa Clara County cities.

The Association was formed through a joint powers agreement among the cities of Santa Clara County and was not intended to be a separate public entity. Based on the agreement, the Association does not have the authority to incur any liability binding upon its members or levy any assignment against its members other than the normal dues established pursuant to the agreement.

Basis of Accounting

The Association uses the flow of economic resources measurement focus applied on a full accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when incurred, regardless of the timing of related cash flows.

Operating revenues and expenses generally result from providing and delivering services in connection with Association operations. The principal operating revenue of the Association includes membership dues. Primary operating expenses include salaries and benefits, rent, and conferences. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

When both restricted and unrestricted resources are available for use, it is the Association's policy to use restricted resources first, and then unrestricted resources, as they are needed.

Under GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Association has elected not to apply Financial Accounting Standards Board statements and interpretations issued after November 30, 1989.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

NOTE 1 – **SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include investments purchased with an initial maturity of three months or less.

Capital Assets

Capital assets are stated at cost. Provision is made for depreciation using the straight-line method over the estimated useful lives of the assets, which range from 2 to 5 years for furniture and equipment. Expenditures for maintenance and repairs are charged to expense as incurred. Purchases of furniture and equipment exceeding $500 are recorded as capital assets. The Association uses the straight line method of depreciation.

Dues Revenue

The Association bills and receives membership dues annually from member cities based on a tiered system depending on the city's size. Dues are generally received in the first quarter of the year billed and are expended throughout the year for operations.

Implementation of Governmental Accounting Standards Board Pronouncements

In fiscal year 2003, the Association adopted three new pronouncements issued by the Governmental Accounting Standards Board (GASB) – GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments,* GASB Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus,* and GASB Statement No. 40, *Deposit and Investment Risk Disclosures—an amendment of GASB Statement No. 3.*

GASB Statements Nos. 34 and 37 state that governments engaged only in business-type activities should present only the financial statements required for enterprise funds. The Association adopted GASB Statements No. 34 and 37 effective for its 2003, 2004, 2005, 2006 and 2007 financial statements. The effect of this change is that the balance sheets; statements of revenues and expenditures; and the statements of changes in reserves and fund balance are replaced with the statements of net assets; statements of revenues, expenses and changes in fund net assets; and statements of cash flows.

GASB Statement No. 40 modifies the custodial credit risk disclosures required by Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements* and addresses deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. The disclosure changes related to implementing this pronouncement are reflected in Note 2.

SANTA CLARA COUNTY CITIES ASSOCIATION
NOTES TO FINANCIAL STATEMENTS (CONTINUED)
FOR THE YEAR ENDED JUNE 30, 2007, 2006, 2005, 2004 AND 2003

NOTE 2 – CASH AND INVESTMENTS

Cash and investments consist of the following as of June 30:

	2007	2006	2005	2004	2003
Deposits with financial institutions	$ 7,644	$ 6,625	$ 10,832	$ 10,788	$ 26,323
Investments in Local Agency Investment Fund	53,486	34,714	37,580	46,442	35,478
Total cash and investments	$ 61,130	$ 41,339	$ 48,412	$ 57,230	$ 61,801

Authorized Investments

The Board of Directors authorized the Association to invest in the California Local Agency Investment Fund (LAIF) and certificates of deposit placed with commercial banks and/or savings and loan institutions. The Association does not have an investment policy on interest rate, credit or custodial credit risks. The Association is a voluntary participant in LAIF. LAIF is part of the State of California's Pooled Money Investment Account (PMIA). PMIA is not SEC registered and not rated, but is required to invest according to California State Government Code. The weighted average maturity of PMIA investments was under 1 year as of June 30, 2007, 2006, 2005, 2004 and 2003. The Local Investment Advisory Board (LIAB) has oversight responsibility for LAIF. The LIAB consists of five members as designated by state statute. The value of the pool shares in LAIF, which may be withdrawn, is determined on an amortized cost basis, which is different than the fair value of the Association's portion of the pool. The Association's portion of LAIF may be withdrawn on demand.

NOTE 3 – CAPITAL ASSETS

Capital assets activity for the each of the years ended is as follows:

	Year Ended June 30,				
	2007	2006	2005	2004	2003
Furniture and equipment, beginning	$ 12,701	$ 12,701	$ 10,590	$ 10,590	$ 10,590
Additions	-	-	2,111	-	-
Reductions	(4,807)	-	-	-	-
Furniture and equipment, ending	7,894	12,701	12,701	10,590	10,590
Accumulated depreciation, beginning	(11,188)	(10,766)	(10,590)	(10,590)	(10,590)
Additions	(422)	(422)	(176)	-	-
Reductions	4,807	-	-	-	-
Accumulated depreciation, ending	(6,803)	(11,188)	(10,766)	(10,590)	(10,590)
Furniture and equipment, net	$ 1,091	$ 1,513	$ 1,935	$ -	$ -

NOTE 4 – **DESIGNATION OF ASSOCIATION FUNDS**

In September 1997, the Association adopted a policy to set up certain reserves (designations). As of year-end the designations were as follows:

	June 30, 2007	2006	2005	2004	2003
Operations	$ 35,000	$ 35,000	$ 35,000	$ 35,000	$ 35,000
Equipment replacement	5,000	5,000	5,000	5,000	5,000
Total designated net assets	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000

SANTA CLARA COUNTY CITIES ASSOCIATION

Report to the Board of Directors

For the Years Ended June 30, 2007, 2006, 2005, 2004 and 2003

MACIAS GINI & O'CONNELL LLP

CERTIFIED PUBLIC ACCOUNTANTS & MANAGEMENT CONSULTANTS

SANTA CLARA COUNTY CITIES ASSOCIATION
FOR THE YEARS ENDED
JUNE 30, 2007, 2006, 2005, 2004 AND 2003

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Board of Directors
Santa Clara County Cities Association
Sunnyvale, California

In planning and performing our audit of the basic financial statements of the Santa Clara County Cities Association (Association) as of and for the years ended June 30, 2003, 2004, 2005, 2006 and 2007 in accordance with auditing standards generally accepted in the United States of America, we considered the Association'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 Association's internal control. Accordingly, we do not express an opinion on the effectiveness of the Association'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 and other deficiencies that we consider to be material weaknesses.

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, 2007 C, 2007 D and 2007 E to be significant deficiencies in internal control.

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, 2007 B, 2007 C, 2007 D, and 2007 E constitute material weaknesses.

The Association's written response to the findings identified in our audit is described in the Schedule of Comments and Responses. We did not audit the Association's response and, accordingly, we express no opinion on it. In addition, we have already discussed our comments and recommendations with the Association's 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 Board of Directors as required by auditing standards generally accepted in the United States of America.

This communication is intended solely for the information and use of Board of Directors, management, 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

March 28, 2008

SANTA CLARA COUNTY CITIES ASSOCIATION
FOR THE YEARS ENDED
JUNE 30, 2007, 2006, 2005, 2004 AND 2003

REQUIRED COMMUNICATIONS

We have audited the basic financial statements of the Santa Clara County Cities Association (Association) for the years ended June 30, 2003, 2004, 2005, 2006, and 2007, and have issued our report thereon dated March 28, 2008. 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 letter dated March 4, 2008, 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 of material misstatement 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 Association. 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 Association, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the Association are described in Note 1 to the Association's basic financial statements. With the exception of the item described below, no new accounting policies were adopted and the application of existing policies was not changed during the years ended June 30, 2003, 2004, 2005, 2006 and 2007.

New Reporting Model - As described in Note 1 to the Association's basic financial statements, in fiscal year 2003, the Association adopted three new pronouncements issued by the Governmental Accounting Standards Board (GASB) – GASB Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, GASB Statement No. 37, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus*, and GASB Statement No. 40, *Deposit and Investment Risk Disclosures—an amendment of GASB Statement No. 3*. GASB Statements No. 34 and 37 state that governments engaged only in business-type activities should present only the financial statements required for enterprise funds. The effect of this change is that the balance sheets; statements of revenues and expenditures; and the statements of changes in reserves and fund balance are replaced with the statements of net assets; statements of revenues, expenses and changes in fund net assets; and statements of cash flows. GASB Statement No. 40 modifies the disclosure requirements related to cash and investments and the impact of this change is reflected in Note 2 to the Associations basic financial statements.

We noted no transactions entered into by the Association during the periods under audit 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.

REQUIRED COMMUNICATIONS (Continued)

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 depreciation estimates for capital assets, including depreciation methods and useful lives assigned to depreciable property.

Management's judgments and estimates on the useful lives for depreciable property were based on the nature of the capital asset.

We evaluated the key factors and assumptions used to develop these accounting estimates in determining that they are reasonable in relation to the basic financial statements taken as a whole.

IV. Audit Adjustments

For 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 Association's financial reporting process (that is, cause future financial statements to be materially misstated). The Association's audit adjustments, in our judgment, indicate matters that could have a significant effect on the Association's financial reporting process.

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 financial statements taken as a whole.

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 Association'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.

REQUIRED COMMUNICATIONS (Continued)

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 Association'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 - Internal Controls Over Financial Reporting

During our initial review of the Association's trial balances, we noted the following deficiencies:

(1) Beginning net assets equity balances did not reconcile to the last audited financial statements (June 30, 2002) in the amount of $1,099.

(2) The trial balance for the year ended June 30, 2007 did not include the Association's cash receipts in the amount of $7,345 which was deposited with the bank as of June 30, 2007.

(3) The financial statements presented to the Board of Directors for years ended June 30, 2005 and 2006 did not reflect accurate information. Unbudgeted capital expenditures incurred in 2005 in the amount of $2,111 but unpaid were recorded in the following fiscal year.

In addition, we noted that monthly bank reconciliations were not prepared timely and appropriately. For example, bank reconciliation for the months of June 2005, June 2006 and June 2007 did not agree to bank statements.

The Association did not maintain effective controls over the financial reporting process. Specifically, the Association did not have on staff personnel with an appropriate level of accounting knowledge, experience and training in the application of GAAP commensurate with the Association's financial reporting requirements. This control deficiency could result in a misstatement of account balances that would result in a material misstatement to annual financial statements that would not be prevented or detected. As a result, the Association may not be generating accurate financial information to analyze its operations. Accordingly, this control deficiency constitutes a material weakness.

We recommend that the Association provide accounting training to reduce the likelihood that errors may occur and therefore improve internal controls over financial reporting. In conjunction with the training program the Association should develop instructions and procedures that include timely preparation and review of the monthly bank reconciliations.

Management Response:

- **Asset Reconciliation:** The Association recognizes that its capital asset reporting has been weak. However, because the asset base is small and relatively static, asset reporting and analysis hasn't been a focus or concern of the Board, nor has the lack of thorough reporting hindered the Association's operations or policies. Note: Most of the assets are greater than ten years in age and some received as donations in "used condition". Only the portable computer and printer are thought to have value.

- **Trial Balance for June 30, 2007**: The $7,345 deposit in question was a member city's dues payment for fiscal 2007-2008. The payment was received and deposited early as to not lose the check (i.e. June 20, 2007, in fiscal 2006-2007), but not reported until the following month, on July 5, 2007 as it was revenue for FY 2007-08. The misreporting did not cause any budgetary, control, governance, or policy problems. In the future, early deposits will be recorded promptly as "pre-payments" and then reconciled the following month.

- **Unbudgeted Capital Expenditure for FY 2004-05 Recorded in FY 2005-06**: This reporting (for a $2,111 personal computer purchase) was done incorrectly by the Association's former Executive Director (ED). (The computer was purchased with board approval in spring 2006, but not recorded in the register until summer, when it was "supported" by the next year's budget.) The error was due to misunderstanding of accounting principles by the former ED, and did not jeopardize the Association's operations or programs.

SCHEDULE OF COMMENTS AND RESPONSES (Continued)

- **Monthly Bank Reconciliations:** The reconciliations in question (June 2005, 2006, 2007) differed by the same constant amount from bank the statements due to a very old, obscure (and challenging to find) mistaken entry in the QuickBooks register. It is interesting to note that this error went undetected in June 2005 even though that reconciliation was performed by an outside CPA (it was SCCCA's practice at the time to have quarterly reconciliations performed by an outside bookkeeper.) Although the error was detected in subsequent reconciliations, the Executive Director felt it was inappropriate to force a "journal entry" correction into the register. However, due to the persistence and diligence of this audit, the error has been recognized and will be corrected.

- **Recommendation To Provide Accounting Training:** The Association's Executive Director has learned from the errors of the past and knows how to properly record and report financial transactions. She will prepare the recommended instructions and procedures.

Item #2007 B - Segregation of Duties

Although the small size of the Association's office staff limits the extent of separation of duties; we believe certain steps could be taken to separate incompatible duties. The basic premise is that no one employee should have access to both physical assets and the related accounting records or to all phases of a transaction. One of the most critical areas of separation of duties is cash, where we noted that the Executive Director handles incoming checks, prepare the cash deposits, and receive and reconcile the monthly bank statements. In addition, the Executive Director has the authority to make purchases, approve invoices, and signs checks up to $2,000 without a secondary approval.

We recommend that the Association assigns a Board member or hire a bookkeeper to perform the monthly cash reconciliations as a way to review the Association's monthly cash activities.

Management Response:

The Board's Treasurer will be asked to review each month's bank account reconciliation. We feel that it is inappropriate to request the Treasurer to perform the actual reconciliation task as the Association's board members are unpaid volunteers, and, as elected officials for their member cities, are generally fully consumed with other duties and responsibilities. The Association understands this Audit finding, and believes that the risk of its approach is acceptable due to:

- The Association's relatively small amount of cash flow (i.e., < $100K annually)
- The relatively few and seasonal nature of the Association's cash intakes (i.e., in July for member city dues, and December and March for membership dinners)
- The fact that the bulk of the Association's expenditures are for regular monthly payroll costs, with processing and reporting performed an accredited third party vendor.
- The Board's monthly review of budget vs. actual reports, and transaction reports which detail each expenditure.
- The personal integrity of the Association's Executive Director (employee).

It's interesting to note that the alternative recommendation to hire a bookkeeper to reconcile bank statements was actually the Association's practice prior to 2006. The practice was discontinued as a cost saving measure when the current Executive Director was hired.

SCHEDULE OF COMMENTS AND RESPONSES (Continued)

Item #2007 C - Payroll Accounting

During our audit, we noted that the Association depends on a third-party provider for payroll processing. The Executive Director provides her employee information and pay rate to the third-party provider and the third-party provider generates payroll reports, employee paychecks, and payroll tax returns. During our audit, we noted that for the years ended June 2003, 2004, and 2006 the employee portion of payroll tax was not correctly recorded as wages in the trial balance. Instead, the Association recorded the employee's portion of the payroll tax as an Association operating expense. In addition, during November 2005, we noted that the Association recorded payroll tax expense in the amount of $1,023 twice for the same pay period which overstated operating expenses.

We recommend that the Association review payroll reports, reconcile amounts reported as payroll expense and payroll tax expense to its general ledger.

Management Response:

This error was due to misunderstanding of accounting principles by the former Executive Director. The error was actually detected by the current ED (reference November 20, 2006 Memo to File; Subject: "Accounting changes for payroll transactions") and corrected for the FY2006-07. Before implementation, the problem and correction were reviewed with the then current Board Treasurer and auditor (City of San Jose's Office of the City Auditor.) As part of those reviews, it was decided not to correct and reissue financial reports for fiscal years prior to 2006-07, as this would be both burdensome and of no particular benefit to the Association.

The Association has been properly adhering to the recommendation since November 2006, when the above mentioned error was first detected and corrected. It is noted that the Board's monthly review of budget vs. actual reports, and transaction reports includes all payroll expenses. Also, the payroll budget has been quite accurate, with monthly expenses being generally constant and highly predictable.

Item #2007 D - Payroll Laws and Regulations Compliance

During our audit we noted an employee was provided medical insurance allowance in fiscal years June 30, 2003, 2004, 2005 and 2006 in the amount of $8,381, $10,719, $13,725 and $5,100, respectively, since the Association did not offer a health plan to its employee. Generally, contributions made by an employer to a health insurance plan providing insurance for its employees and their spouses and dependents are not wages and are not subject to federal income tax withholding or social security, Medicare, and federal unemployment taxes. On the other hand, contributions made by employees from their wages for health insurance must be included in their income for income withholding and employment tax purposes unless the contributions are made through a valid cafeteria plan. As a result, this allowance appears to be subject to income tax withholdings. However, the Association did not subject this allowance to income tax withholdings.

We recommend that the Association review the past allowance provided to its employee with a tax accountant and pursue a remedy to this potential liability. In addition, the Association should improve its staff's proficiency with current payroll laws and regulations.

SCHEDULE OF COMMENTS AND RESPONSES (Continued)

Management Response:

This matter will be raised at the April meeting of the Association's Executive Board. It's noted that the health insurance reimbursements were unique to the previous Executive Director, and that the Association no longer allows such payments. Also, if it's determined that the reimbursement are in fact, employee income, and that the Association is responsible for payment of the employer's share of state and federal taxes, then the cost to SCCCA is not trivial (e.g., state and federal taxes on additional $38K of income is expected to be approximately $2,900. In addition the Association may have to pay interest and/or penalties, as well as pay its payroll vendor to issue corrected W2 forms to the ex-employee.

Item #2007 E - Capital Asset Records

The Association does not have policies and procedures to ensure that its accounting for capital asset acquisitions and retirements complied with generally accepted accounting principles. Although capital assets are recorded in the general ledger system, a permanent record of all capital assets with cost, depreciable life, accumulated depreciation, and book value is not updated for annual activity. As a result, the Association did not capture a laptop purchased in the amount of $2,111 and did not remove assets no longer in service in the amount of $4,807 from its records.

We recommend that the Association maintain a current record of its capital assets. The data should include the date the asset is acquired, a description of the asset, the amount, the depreciation method, the life of the asset, the monthly depreciation, and the book value. The capital assets accounts should be reconciled periodically so that discrepancies can be researched and resolved. In addition, the Association should perform an annual inventory of its capital assets against its capital assets listing to ensure that its assets are in place and in use.

Management Response:

Because the Association's asset base is small and quite static, asset reporting and analysis hasn't been a focus or concern of the Board. Likewise, the lack of complete asset reporting hasn't hindered the Association's operations or policies. (Note: Most of the assets are greater than ten years in age and some were received as donations in "used condition". Only the portable computer and printer are thought to have value.) However, the Association recognizes that its capital asset reporting has been weak and commits to improvement. The Association will inventory its assets and perform the requested reporting.

SANTA CLARA COUNTY CITIES ASSOCIATION
FOR THE YEARS ENDED
JUNE 30, 2007, 2006, 2005, 2004 AND 2003

UNCORRECTED FINANCIAL STATEMENT MISSTATEMENTS

PROPOSE PJE in FY	PJE #	ACCOUNT NAME	BALANCE SHEET DEBIT	BALANCE SHEET CREDIT	INCOME STATEMENT DEBIT	INCOME STATEMENT CREDIT
2007	1	Interest income			243	
		LAIF		243		
		To adjust the LAIF balance to reflect fair value at year end.				
2004	2	Worker's comp. insurance expense			595	
		Accrued expenses		595		
2005		Net assets, beginning	595			595
		Worker's comp. insurance expense				
		To record accrual of worker's comp. insurance expense for FY 2004 and reverse the impact in FY2005.				
2003	3	Payroll tax expense			641	
		Accrued payroll taxes		641		
		To accrue estimated employer payroll tax liability on medical allowance for FY2003.				
2004	4	Payroll tax expense			820	
		Beginning net assets			641	
		Accrued payroll taxes		1,461		
		To accrue estimated employer payroll tax liability on medical allowance for FY2004 and record prior year's impact.				
2005	5	Payroll tax expense			1,050	
		Beginning net assets			1,461	
		Accrued payroll taxes		2,511		
		To accrue estimated employer payroll tax liability on medical allowance for FY2005 and record prior year's impact.				
2006	6	Payroll tax expense			390	
		Beginning net assets			2,511	
		Accrued payroll taxes		2,901		
		To accrue estimated employer payroll tax liability on medical allowance for FY2006 and record prior year's impact				
2003	7	Cash- Graffetti CD	48			
		Interest income				48
		To reconcile the balance to the CD bank statement.				