

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Independent Auditor's Reports,
Management's Discussion and Analysis, and
Basic Financial Statements

For the Year Ended June 30, 2020



Certified
Public
Accountants

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

For the Year Ended June 30, 2020

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Independent Auditor's Report

Governing Board of the
County Sanitation District No. 2-3 of Santa Clara County
San Jose, California

Report on the Financial Statements

We have audited the accompanying financial statements of the County Sanitation District No. 2-3 of Santa Clara County (District), as of and for the year ended June 30, 2020, and the related notes to the financial statements, which collectively comprise the District's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the District as of June 30, 2020, and the changes in its financial position and its cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated February 8, 2021, on our consideration of the District's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the District's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the District's internal control over financial reporting and compliance.



Walnut Creek, California
February 8, 2021

COUNTY SANITATION DISTRICT NO. 2-3 OF SANTA CLARA COUNTY

Management's Discussion and Analysis (Unaudited)
For the Year Ended June 30, 2020

This section of the County Sanitation District No. 2-3 of Santa Clara County's (District) annual financial report presents a discussion and analysis of the District's financial performance during the fiscal year ended June 30, 2020. Please read it in conjunction with the District's basic financial statements following this section.

History and Organization

The District, while a component unit of the County of Santa Clara (County), is a separate government entity established as a special district of the State of California. Being a dependent special district, the County Board of Supervisors sits as the District's governing Board of Directors. The District is presented as a blended component unit of the County as the County has financial and operational responsibility for the District and the services provided by the District benefit the County. The District was consolidated in December 1977 by the merger of Districts 2 and 3, which were originally formed in May 1948 and May 1953, respectively. The District serves the unincorporated areas of East San Jose in the vicinity of the Alum Rock area (District 2) and unincorporated areas including the County Fairgrounds and environs southerly (District 3). The District provides sewage collection, treatment, and disposal services for these areas comprising approximately 3.8 square miles with nearly 46 miles of sewer lines to maintain. Revenues are derived principally from sewer service charges collected annually with property taxes from commercial and residential users within the District.

Operations and Management

The District's sewage flows are collected by District-owned mains and then transmitted through joint use sewer mains owned by the City of San Jose (City) to the San Jose-Santa Clara Regional Wastewater Facility (RWF) for treatment and disposal. The District and the City have entered into a contractual agreement to co-share cost of expenses related to these joint use sewer mains. The current joint interceptor cost sharing agreement, which supplanted all prior agreements, was executed on September 29, 1992 and provided for proportionate cost sharing, based on the agreed capacities and flows, between the City and the District for construction, operation and maintenance or rehabilitation of joint use sewer lines. This agreement expired on September 29, 2009. The District and the City are currently in negotiation for a new agreement. Although the agreement has not yet been executed, there will be a continual obligation by the District to pay the City. This amount has not yet been determined, but it is anticipated that the new amount would be lower than the original agreement amount. Once a new agreement is executed, the District will pay its obligation share to the City from September 29, 2009 onwards.

Costs for capital improvements, operation, and maintenance of wastewater treatment, and disposal are based upon the terms of a Master Agreement between the Cities of San Jose and Santa Clara, owners of the RWF, with the District, dated January 1, 1985.

This agreement also includes a reimbursement to the City of San Jose for a long-term obligation for a proportionate share of the debt service on bonds issued in 1995 for the construction and expansion of the RWF to satisfy state and federal permit requirements. The outstanding balances of the bonds were refinanced in 2005. The City of San Jose adopted "The Plant Master Plan" in November 2013, which includes rehabilitation and improvements at the RWF of \$1.4 billion over the 10 year period, for which the District will be responsible for its prorated share (0.58%), estimated at \$7,685,000. It is the District's position that the 1985 agreement does not cover the cost, financing or implementation of these capital

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Management's Discussion and Analysis (Unaudited)
For the Year Ended June 30, 2020

improvement projects at the RWF and a new agreement or an amendment to the 1985 agreement would be needed. The District and the City of San Jose are in negotiation at this time. For the past five years, the District has been paying these RWF capital improvement costs under protest, until a new agreement/amendment is executed. Under the 1985 agreement, the District has no ownership interest in the RWF and the District leases capacity and makes payments on a calculated schedule based on flow capacity.

The District's management is provided by contractual agreement with Mark Thomas & Company Inc., a private consultant responsible for day-to-day administration and operation of the District. The Santa Clara County Roads and Airport provides management oversight of the District's activities. Repairs and maintenance activities are provided as scheduled or needed with outside contractors.

Financial Statements Analysis

The following table summarizes the net position of the District at June 30, 2020 and 2019:

Condensed Statement of Net Position

	2020	2019	Change
Assets			
Current assets	\$ 4,976,141	\$ 5,872,116	\$ (895,975)
Capital assets, net	3,946,080	3,895,022	51,058
Total assets	8,922,221	9,767,138	(844,917)
Liabilities			
Current Liabilities	635,668	606,982	28,686
Total liabilities	635,668	606,982	28,686
Net position			
Net investment in capital assets	3,946,080	3,895,022	51,058
Unrestricted net position	4,340,473	5,265,134	(924,661)
Total net position	\$ 8,286,553	\$ 9,160,156	\$ (873,603)

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Management's Discussion and Analysis (Unaudited)
For the Year Ended June 30, 2020

The statement of activities identified the various revenues and expenses items, which impact the changes in net position. The following table summarizes the changes in net position for the years ended June 30, 2020 and 2019.

Condensed Statements of Revenues, Expenses, and Changes in Fund Net Position

	<u>2020</u>	<u>2019</u>	<u>Change</u>
Operating revenue	\$ 3,199,498	\$ 3,028,750	\$ 170,748
Non-operating revenue	230,901	93,657	137,244
Total revenues	<u>3,430,399</u>	<u>3,122,407</u>	<u>307,992</u>
Operating expenses	4,304,002	2,768,779	1,535,223
Change in fund net position	(873,603)	353,628	(1,227,231)
Net position, beginning	9,160,156	8,806,528	353,628
Net position, ending	<u>\$ 8,286,553</u>	<u>\$ 9,160,156</u>	<u>\$ (873,603)</u>

Total net positions for the end of fiscal years ended June 30, 2020 and 2019 were \$8,286,553 and \$9,160,156, respectively. Change in net position is a decrease of \$873,603 or 9.5%. Of the \$4.3 million in operating expenses, \$2.9 million is attributed to amount paid to the City for the operation and maintenance of the treatment plan. The District's management decided to not implement the capital project budgeted at \$3,100,000 for the year ended June 30, 2020. This was decided to preserve cash for the District's share of capital contribution for the treatment plant and the potential for the County to fund future capital projects. Because of the increase in treatment plant expenses, the additional cost to administer, manage, repair and maintain the District, coupled with no rate increase to the rate payers, net position decreased for the year.

Unrestricted net position decreased by 17.6% to \$4,340,473 as compared to prior year's \$5,265,134. This decrease is primarily due to the decrease in current assets, which is mainly comprised of decrease in cash and cash equivalents from operations as explained in the previous paragraph.

The increase in operating revenue of 5.6% (\$3,199,498 as compared to prior year's \$3,028,750) is primarily due to a larger credit received from the City for the operations and maintenance and capital costs from the prior year final cost reconciliation.

The increase in non-operating revenue of 146.5% (\$230,901 as compared to prior year's \$93,657) is due to increase in investment income. The increase is primarily due to the increase in return on investment from the County Treasurer's pool and impact of fair value adjustment for the year.

The increase of operating expenses of 55.4% (\$4,304,002 as compared prior year's \$2,768,779) is primarily due to increase in payments to the City for the operation and maintenance of the treatment plan to \$2,885,652 as compared to prior year's \$1,591,983.

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Management's Discussion and Analysis (Unaudited)
For the Year Ended June 30, 2020

Budgetary Highlights

As a dependent special district, County Sanitation District 2 3 is subject to the County Budget Act, which specifies the content and presentation of the budget information to the Board of Supervisors. The annual budget for the current fiscal year was adopted by the Board of Directors, which outlines the major elements of forthcoming operations and capital projects.

Capital Assets

As of June 30, 2020, the District had net capital assets amounting to \$3,946,080 representing investments in sewer substructure system consisting of subsurface mains and laterals. Capital assets balance remained consistent when compared to prior year mainly due to minimal capital projects for the year.

Rates and Other Economic Factors

The District considers many factors when setting the fiscal year budget. Some of those factors are the economy, increased salaries and the cost of benefits for both the District's operations and the San Jose/Santa Clara Regional Wastewater facility's operations and maintenance, as well as increased capital improvement programs at the RWF and the District's own capital needs. In addition, the District's operations are governed in part by the requirements and provisions of the State Water Resource Control Board that require adequate funding to cover the costs of operations, maintenance and recurring capital replacement (OM&R) to be in compliance with the Sewer System Management Plan (SSMP).

The District is not affected by general economic conditions such as increases or reductions in property tax values or other types of revenues, such as sales taxes, that vary with economic conditions. Accordingly, the District sets its rates to its users to cover the costs of OM&R, capital improvement projects, plus any increments for known or anticipated changes in program costs. Based on uncertainty with the financing of the San Jose-Santa Clara Regional Wastewater Facility and the plans for the District's capital improvement projects, the fact that the District is a dependent district of the County, and the economic hardships and uncertainty surrounding the COVID-19 pandemic, the District did not increase sewer services charges for this fiscal year.

Future Considerations

There are still approximately 500 homes remaining for potential pocket annexations, but there is no current plan by the City to move forward with annexation.

The District, with the other Tributary Agencies (West Valley Sanitation District, City of Milpitas, Burbank Sanitary District and the Cupertino Sanitary District), filed a lawsuit alleging several causes of action in the complaint (Refer to Note 6 to the basic financial statements for details). Moving forward, adjustment to the user's rate will need to factor in the outcome of this lawsuit.

The District and the City have not yet completed negotiation of a new agreement for the cost sharing of the joint interceptor. Refer to Page 3, Operations and Management section, for details.

Requests for Financial Information

This financial report is designed to provide our customers and creditors with a general overview of District finances and demonstrate District fiscal accountability for the money it receives. If you have any questions about this report, or need additional financial information, contact the District Administrative Office, 20863 Stevens Creek Blvd., Ste 100, Cupertino, CA. 95014, Ph. (408) 255-2137.

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Statement of Net Position
June 30, 2020

Assets

Current assets:

Cash and cash equivalents	\$ 4,932,627
Interest receivable	20,700
Prepaid expense	22,814
Total current assets	<u>4,976,141</u>

Noncurrent assets:

Depreciable capital assets, net	<u>3,946,080</u>
Total assets	<u><u>8,922,221</u></u>

Liabilities

Current liabilities:

Accounts payable	632,724
Other liabilities	2,944
Total liabilities	<u><u>635,668</u></u>

Net Position

Investment in capital assets	3,946,080
Unrestricted	4,340,473
Total net position	<u><u>\$ 8,286,553</u></u>

The accompanying notes are an integral part of these basic financial statements.

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Statement of Revenues, Expenses, and Changes in Net Position
For the Year Ended June 30, 2020

Operating revenues:	
Sewer service charges	\$ 2,742,575
Permits, inspection, and other fees	22,396
Miscellaneous income	434,527
Total operating revenues	3,199,498
 Operating expenses:	
Sewage treatment	2,885,652
County agenda fees	11,000
Management & engineering	232,218
Repairs & maintenance	888,504
Accounting & clerical	55,197
Legal services	62,850
Audit services	17,300
Office expenses	1,565
Depreciation	78,004
Membership fees	11,538
Insurance	45,571
Other	14,603
Total operating expenses	4,304,002
Operating loss	(1,104,504)
 Nonoperating revenues:	
Investment income	230,901
Change in net position	(873,603)
Net position, beginning of year	9,160,156
Net position, end of year	\$ 8,286,553

The accompanying notes are an integral part of these basic financial statements.

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Statement of Cash Flows
For the Year Ended June 30, 2020

Cash flows from operating activities	
Cash receipts from customers and users	\$ 3,199,498
Cash payment to suppliers for goods and services	<u>(4,197,369)</u>
Net cash used in operating activities	<u>(997,871)</u>
Cash flows from capital and related financing activities:	
Acquisition of capital assets	<u>(129,062)</u>
Cash Flows Provided by Investing Activities:	
Interest received	<u>230,901</u>
Net change in cash and cash equivalents	<u>(896,032)</u>
Cash and cash equivalents, beginning of year	<u>5,828,659</u>
Cash and cash equivalents, end of year	<u><u>\$ 4,932,627</u></u>
Reconciliation of operating loss to net cash used in operating activities	
Operating loss	\$ (1,104,504)
Adjustments to reconcile operating loss to net cash used in operating activities:	
Depreciation	78,004
(Increase) decrease in assets:	
Prepaid and other assets	(57)
Increase (decrease) in liabilities:	
Accounts payable	<u>28,686</u>
Net cash used in operating activities	<u><u>\$ (997,871)</u></u>

The accompanying notes are an integral part of these basic financial statements.

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**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Notes to Basic Financial Statements
For the Year Ended June 30, 2020

NOTE 1 – REPORTING ENTITY

County Sanitation District No. 2-3 of Santa Clara County (District), while a component unit of the County of Santa Clara (County), is a separate government entity established as a special district of the State of California. Being a dependent special district, the County Board of Supervisors sits as the District's governing Board of Directors. The District is presented as a blended component unit of the County as the County has financial and operational responsibility for the District and the services provided by the District benefit the County. The District was consolidated in December 1977 by the merger of Districts 2 and 3, which were originally formed in May 1948 and May 1953, respectively. The District serves the unincorporated areas of East San Jose in the vicinity of the Alum Rock area (District 2) and unincorporated areas including the County Fairgrounds and environs southerly (District 3). The District provides sewage collection, treatment, and disposal services for these areas comprising approximately 3.8 square miles with nearly 46 miles of sewer lines to maintain. Revenues are derived principally from sewer service charges collected annually with property taxes from commercial and residential users within the District.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Accounting

The accounts of the District are organized on the basis of a proprietary fund type, specifically an enterprise fund. The activities of this fund are accounted for with a separate set of self-balancing accounts that comprise the District's assets, deferred outflows of resources, liabilities, deferred inflows of resources, net position, revenues and expenses. Enterprise funds are used to account for activities that are financed with debt that is secured solely by a pledge of the net revenues from fees and charges for the activity.

The financial statements of the District have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial principles.

The accounting and financial reporting treatment applied to the District is determined by its measurement focus. The transactions of the District are accounted for using the flow of economic resources measurement focus. With this measurement focus, all assets, deferred outflows of resources, liabilities and deferred inflows of resources associated with the operations are included on the statements of net position. Revenues are recorded when earned and expenses are recorded when the related liabilities are incurred.

Enterprise funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services in connection with the entity's principal ongoing operations. The principal operating revenue of the District is sewer service charges. Operating expenses for the District include costs of sewage treatment and repairs, maintenance, management, and engineering. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Notes to Basic Financial Statement (Continued)
For the Year Ended June 30, 2020

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Cash and Cash Equivalents

All of the District's cash and cash equivalents are deposited in the County Treasurer's pool. Investments in the pool are made in accordance with the County's investment policy as approved by the Board of Supervisors. The County's Treasury Oversight Committee is responsible for the regulatory oversight of the County Treasurer's pool. Investments are stated at fair value in accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Pools* and GASB Statement No. 72, *Fair Value Measurement and Application*. However, the value of the pool shares in the County Treasurer's pool that may be withdrawn is determined on an amortized cost basis, which is different from the fair value of the District's position in the pool. Interest earned from time deposits and investments is allocated quarterly to the Fund based on its average daily cash balance. At June 30, 2020, the County's Treasurer's pool has a weighted average to maturity of 517 days and is unrated. The District's investments in the County Treasury's Pool are exempt from fair value hierarchy disclosure. Additional information regarding deposit and investment custodial credit, interest rate, credit, and concentration of credit risks of the County's Treasury pool can be found in the notes to the County's basic financial statements.

For purposes of the accompanying statement of cash flows, the District considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Deposits in the County Treasurer's pool are in substance demand deposits and are, therefore, considered cash equivalents for the purpose of the statement of cash flows.

Capital Assets

Capital assets, which include sewer substructure system, are valued at historical cost. Donated capital assets, donated works of art and similar items, and capital assets received in a service concession arrangement are valued at their acquisition value. Capital assets are defined as assets with an initial, individual cost of more than \$5,000 and an estimated useful life in excess of one year. Capital assets used in operations are depreciated using the straight-line method over the estimated useful lives. The estimated useful lives are 50 years for sewer substructure system and 20 years for equipment and pump stations.

Sewer Service Charges

The District receives a major portion of its revenue from sewer service charges that are collected on the County's tax roll twice a year. Sewer service charges are billed and collected, on behalf of the District, by the County Tax Collector as a separate component of the semi-annual property tax billings. The County remits to the District the total amount collected.

Sewer Connection Fees

Sewer connection fees represent one-time charges, which are due upon connection to the system. The District collects these fees on behalf of the San Jose/Santa Clara Water Pollution Control Plant and remits them by warrant to the City of San Jose.

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Notes to Basic Financial Statement (Continued)
For the Year Ended June 30, 2020

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Net Position

The District utilizes a net position presentation. Net position of the District is comprised of the following:

Investment in Capital Assets - This category groups all capital assets into one component of net position. Accumulated depreciation and any outstanding balances of debt that are attributable to the acquisition, construction, or improvement of these assets reduce the balance in this category.

Restricted Net Position - This category consists of restricted assets reduced by liabilities and deferred inflows of resources related to those assets. The District has no restricted net position as of June 30, 2020.

Unrestricted Net Position - This category represents net position of the District not restricted for any project or purpose.

Effects of New Pronouncements

As of July 1, 2019, the District implemented the following GASB Statement:

In May 2020, the GASB issued Statement No. 95, *Postponement of the Effective Dates of Certain Authoritative Guidance*. This primary objective of this statement is to provide temporary relief to governments and other stakeholders in light of the COVID-19 pandemic. The objective is accomplished by postponing the effective dates of certain provisions in GASB Statements and Implementation Guides that first became effective or are scheduled to become effective for period beginning after June 15, 2018, and later. Implementation of this statement did not have a significant impact on the District’s financial statements for the fiscal year ended June 30, 2020.

Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts in the financial statements and accompanying notes. Actual results could differ from those estimates.

NOTE 3 – CAPITAL ASSETS

A summary of changes in capital assets for the year ended June 30, 2020 is as follows:

	Balance at July 1, 2019	Additions	Balance at June 30, 2020
<i>Capital assets, being depreciated:</i>			
Sewer substructure system	\$ 6,362,970	\$ 129,062	\$ 6,492,032
<i>Less accumulated depreciation for:</i>			
Sewer substructure system	<u>(2,467,948)</u>	<u>(78,004)</u>	<u>(2,545,952)</u>
Total capital assets, being depreciated, net	<u>\$ 3,895,022</u>	<u>\$ 51,058</u>	<u>\$ 3,946,080</u>

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Notes to Basic Financial Statement (Continued)
For the Year Ended June 30, 2020

NOTE 4 – ACCOUNTS PAYABLE

The District's accounts payable was \$632,724 as of June 30, 2020. The majority of this balance represents maintenance and operation services payable to the City of San Jose totaling \$573,395 originally accrued in the year ended June 30, 2013. No payment is expected until a new agreement is executed between the District and the City of San Jose. Refer to Note 6 for additional details.

NOTE 5 – SEWER TREATMENT FACILITIES AND CAPACITY RIGHTS

The District has an agreement, dated July 1, 1984, for wastewater treatment with the cities of San Jose and Santa Clara relating to the discharge of sewage into the San Jose/Santa Clara Water Pollution Control Plant. The agreement requires the District to pay the shared costs based on allocated flow capacity rights of the total plant capacity, and operation and maintenance based upon actual sewage flow and strengths. Prior year payments made in excess of actual expenditures are credited to the District in the third quarter each year. The City invoices the District quarterly for budgeted cost then reconciles the funds after year end. The agreement also requires the District to pay its share of debt service on the bond issued for plant expansion and water recycling program. For the year ended June 30, 2020, the District's share of the sewage treatment costs was \$2,885,652.

NOTE 6 – COMMITMENTS AND CONTINGENT LIABILITIES

The joint agreement between the City of San Jose and the District executed on September 29, 1992, has expired on September 29, 2009. The District is currently in negotiation with the City of San Jose for a new agreement. It is anticipated that total payment to the City of San Jose for the joint usage of the City's trunk lines will be lower than the original agreement. The District has an outstanding liability recorded as accounts payable in the amount of \$573,395 for estimated unpaid maintenance and operation services.

In a lawsuit filed in Santa Clara County Superior Court on March 23, 2018, the District, alongside the other Tributary Agencies (West Valley Sanitation District, City of Milpitas, Burbank Sanitary District and the Cupertino Sanitary District), alleges several causes of action in the complaint, all associated with a breach of contract whereby the defendants (the Cities of San Jose and Santa Clara) have been overcharging the Tributary Agencies for use of the Regional Wastewater Facility and/or seeking reimbursement for costs outside the scope of the relevant contracts. The lawsuit is in the discovery stage and it is premature to predict the likely outcome of the litigation or identify the amount or range of any potential loss or gain.

NOTE 7 – RISK MANAGEMENT

The District is exposed to various risks of loss related to damage and destruction of property, errors and omissions, and natural disasters for which the District carries California Sanitation Risk Management Authority (CSRMA) Primary Insurance Program with American Alternative Insurance Corporation. CSRMA is formed by a group of California local public entities who executed a certain Joint Exercise of Powers Agreement. In the interval since CSRMA was founded, CSRMA has developed and is currently operating risk management and loss prevention programs related to public liability, auto liability, public officials' errors and omissions, property losses, and workers' compensation risks in which CSRMA's local government entity members may and do participate. The District renews its insurance policy every year.

**COUNTY SANITATION DISTRICT NO. 2-3 OF
SANTA CLARA COUNTY**

Notes to Basic Financial Statement (Continued)
For the Year Ended June 30, 2020

NOTE 8 – UNCERTAINTIES

In March 2020, the World Health Organization declared coronavirus COVID-19 a global pandemic. This contagious disease outbreak which has continued to spread and related public health developments, has adversely affected organizations and its workforce. This has also impacted the economy, the financial markets globally and potentially leading to an economic downturn. It has also disrupted the normal operations of many governmental organizations, including the District. The District expects that this outbreak may impact revenues and operations for future reporting periods. It is not possible for the District to predict the duration and magnitude of the results of the outbreak and its effects on the District's operations at this time.

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**Independent Auditor’s Report on Internal Control Over Financial Reporting and on
Compliance and Other Matters Based on an Audit of Financial Statements
Performed in Accordance With *Government Auditing Standards***

Governing Board of the
County Sanitation District No. 2-3 of Santa Clara County
San Jose, California

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the County Sanitation District No. 2-3 of Santa Clara County (District), as of and for the year ended June 30, 2020, and the related notes to the financial statements, which collectively comprise the District’s basic financial statements, and have issued our report thereon dated February 8, 2021.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the District’s internal control over financial reporting (internal control) 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 District’s internal control. Accordingly, we do not express an opinion on the effectiveness of the District’s internal control.

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. 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 charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the District’s financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the financial statements. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Macias Gini & O'Connell LLP

Walnut Creek, California

February 8, 2021