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COUNCIL MEMBER KEVIN FAULCONER, CHAIR
AND MEMBERS OF THE AUDIT COMMITTEE

RE: Responsibilities of the Audit Committee Under Federal Securities Laws

At the January 29, 2006 meeting of the Audit Committee, the City Attorney was asked what the obligations of Audit Committee members are under the federal securities laws with respect to the review of financial statements. This memorandum provides a brief overview of the relevant legal principles, and is intended to be responsive to that question. We note that the SEC has not provided definitive guidance on the obligations of public officials in reviewing or approving financial statements, but has offered other guidance that may be instructive. For example, the SEC has stated that municipal issuers (including its officials) have potential securities law liability for releases of information reasonably expected to reach investors or the trading markets. We believe the release of the City's Comprehensive Annual Financial Report ("CAFR") constitutes information of this type so care should be taken with respect to its review and approval. Thus, while there are no legal requirements that Audit Committee members independently verify or guaranty the results of the audit information presented to it, the Audit Committee should ensure that processes are in place to make it reasonably likely that any material misstatements or omissions in the City's financial reports would be discovered.

The Audit Committee was established on January 9, 2007, by Rule 6.11.6 of the Rules of the Council in response to the recommendation of Kroll Inc. in its August 8, 2006 report entitled "Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure". While the Audit Committee has not yet developed a charter establishing the scope of its work, it is expected that the Audit Committee will review the City's CAFR and

the various financial statements of its related entities. Kroll Inc. also recommended that “because the City CAFR is an integral component of the financial information provided as part of any debt issuance, the City Council should review and approve its use. . . .” The City Council has not yet taken any action on this recommendation.

The Securities and Exchange Commission [SEC] is principally concerned with the accuracy and completeness of financial information. Rule 10b-5, the general securities anti-fraud rule, provides that it shall be “unlawful for any person to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading. . . .” In a 1994 Interpretive Release (SEC Release No. 33-7049 (March 9, 1994): Interpretive Guidance on the Antifraud Provisions) [Release], the SEC made it clear that municipal governments and their officials have securities law liability for statements that are reasonably expected to reach investors. In an oft-quoted statement contained in the Release, the SEC provides:

A municipal issuer . . . when it releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions. The fact that they are not published for purposes of informing the securities markets does not alter the mandate that they not violate the antifraud proscriptions.

Under Rule 15c2-12, municipal issuers were already on notice that they were liable for misleading disclosures in their offering documents. In 1989, when the SEC adopted Rule 15c2-12 (the rule which, among other things, prohibits broker-dealers from underwriting certain municipal obligations without obtaining a “deemed final” official statement), the SEC noted that “issuers are primarily responsible for the content of their disclosure documents and may be held liable under the federal securities laws for misleading disclosure.” See Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799. Rule 15c2-12 was amended in 1994 to make it unlawful for a broker-dealer to underwrite certain municipal securities unless such broker-dealer has reasonably determined that the issuer has undertaken to provide certain information—continuing disclosure—to nationally recognized municipal securities information repositories.

Similarly, the SEC's 21(a) Report regarding the Orange County bankruptcy (Exchange Release No. 36761 (January 24, 1996)) enunciated two principles with respect to approving official statements that are instructive here: (i) "a public official may not authorize disclosure that the official knows to be false" and (ii) "nor may a public official authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading."

The City's CAFR is analogous to the annual financial reports prepared by a public company and provided to its shareholders. The City Charter requires the Auditor and Comptroller to submit an annual report of the City, including a statement of net assets, and of all its accounts. Standards for issuing the City's CAFR are established by the Governmental Accounting Standards Board and the Government Finance Officers Association. Portions of the City's CAFR are attached to any official statement prepared in connection with the issuance of bonds by the City. The CAFR is also disseminated as part of the City's obligation to provide ongoing financial information to bondholders. The information contained in the CAFR is of great interest to the City's bondholders and its release is both expected and intended to reach the investing public. While the City's CAFR is not specifically a financial disclosure in the context of the City's bond issues, it functions as such and, as a result, securities fraud liability attaches to the information contained in the City's CAFR.

Pursuant to the Disclosure Ordinance (O-19320), the City Auditor is required to certify to the City Council that (i) "the information in the CAFR fairly presents, in all material respects, the financial condition and results of operations of the City" and (ii) "the CAFR does not make an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the lights of the circumstances under which they were made, not misleading." At this time there is no provision in the Disclosure Ordinance requiring the City Council to review or approve the CAFR.

Nevertheless it is expected that the Audit Committee will review the CAFR. While all of the CAFR contains important information, we call particular attention to the following sections for review and discussion by the committee: the management discussion and analysis; the summary of significant accounting policies; contingencies; commitments; and subsequent events. The members of the Audit Committee are not responsible for verifying the work of the City's outside auditors or guarantying their work. However, it would be prudent for the Audit Committee to establish procedures designed to discover any material¹ misstatements or omissions in financial statements, either of the City as a whole or of any component unit. In developing and implementing its procedures, the Audit Committee should ensure that the following questions and concerns are adequately addressed:

- What component unit of the City is reporting?
- Do the component unit's financial statements "roll up" into the City's financial statements? Or, are the financial statements "stand alone."
- What is the name of the audit firm performing the audit and how long has such firm been under contract to perform such audits?
- Was the audit performed in accordance with generally accepted auditing standards (AICPA GAAS standards) or generally accepted government auditing standards (GAO GAGAS standards)?² If not, why?

¹ A fact is "material" if there is a "... substantial likelihood that, under all the circumstances, the omitted fact would have assumed significance in the deliberations of the reasonable investor. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976)

² AICPA is the American Institute of Public Accountants. It is a professional organization which, among other things promulgates the generally accepted auditing standards [GAAS], a set of systematic guidelines used by auditors when conducting audits to ensure the accuracy, consistency and verifiability of the auditors' actions and reports. GAO is the Government Accountability Office. It is the audit and investigation arm of Congress which, among other things promulgates the generally accepted government auditing standards [GAGAS], a set of guidelines in addition to those required under GAAS.

- Has the auditor prepared an unqualified opinion regarding the financial statements? If not, what type of opinion was issued and why?
- Does the audit extend to non-major funds individually or in the aggregate?
- Was the audit performed independently? The Audit Committee should ask how the audit firm maintained its independence during the course of the audit.
- The Audit Committee should have the auditor describe, in general, the audit procedures performed.
- Do the financial statements contain deviations from generally accepted accounting principles [GAAP]?³ If so, why?
- The Audit Committee should have the auditor discuss whether any new accounting principles were adopted, whether any changes were made, or whether the auditor recommends any changes, in the accounting policies used or their application. In particular, the relevant issue is whether the audit applied best or merely permissible principles.
- The Audit Committee should have the auditor describe any significant accounting adjustments affecting the financial statements (prior year as well as current year).
- Did the auditor encounter any difficulties in dealing with management in performing the audit, including whether there were any disagreements with management regarding any accruals, estimates, reserves, or accounting principles. Did the auditor have the full cooperation of management and staff?
- The Audit Committee should ask the audit firm about the quality of the component unit's accounting, internal controls, and the competency of staff. Did the auditor issue a management letter?⁴ What non-material weaknesses or reportable conditions has the auditor noted?
- Were there any accounting issues on which the audit firm sought the advice of other audit firms or regulatory bodies?

³ GAAP is the standard framework of guidelines for financial accounting. It includes the standards, conventions, and rules accountants follow in recording and summarizing transactions, and in the preparation of financial statements.

⁴ A management letter contains required correspondence between the auditor and management which principally contains internal control weaknesses and recommendations.

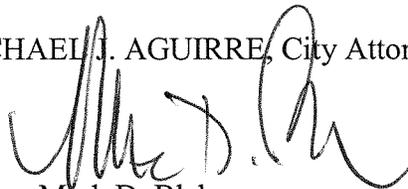
- The Audit Committee should ask the audit firm whether there are new pronouncements and or areas of potential financial risk affecting future financial statements of which the Audit Committee should be aware.

The above list is not exhaustive and is meant to serve as guidance and a starting point. Given the complexity of the task facing members of the Audit Committee, it is recommended that the Audit Committee obtain a consultant or other expert to guide the committee with respect to its review of financial statements.

Should you have any other questions, please feel free to contact me.

MICHAEL J. AGUIRRE, City Attorney

By



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