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MEMORANDUM

May 26, 2011

To: Audit Committee

From: John M. McNally *JMM*
Hawkins Delafield & Wood LLP (outside Disclosure Counsel)

Re: Oversight Role re Audited Financial Statements

Introduction

This memorandum provides advice to the Audit Committee with respect to its oversight role regarding the preparation, review, and publication of the audited financial statements of the City. Exhibit A provides a summary of the principal elements of the Audit Committee's role in this context; Exhibit B lists the key documents that were considered in the preparation of this memorandum.

Overview

This same issue was addressed in a letter from Stan Keller, then Independent Consultant to the City, to Kevin Faulconer, as Audit Committee Chairman, dated March 31, 2009, to which was attached a document entitled "*Process for Review of CAFRs*". Exhibit A to this memorandum represents an update to that *Process* (originally dated May 11, 2007), and reflects revisions made to the Municipal Code in 2010.¹ The processes listed in Exhibit A are sequential, beginning prior to the commencement of the audit process and continuing until the audited financial statements are transmitted to the Electronic Municipal Market Access ("EMMA") system maintained by the Municipal Securities Rulemaking Board, immediately following their receipt and filing by the City Council.

The oversight role of the Audit Committee regarding the annual audit is set forth in §26.1706 of the Municipal Code. There are three key sequential processes set forth in that section - (1) the oversight role of the Audit Committee while the financial statements are in draft form, (2) the oversight role of the Audit Committee once the audit opinion has been issued, and

¹ City of San Diego Ordinance O-19943, adopted March 29, 2010, and effective April 28, 2010, which added to the Municipal Code Chap. 2, Art. 6, Div.17: Audit Committee.

(3) the recommendation by the Audit Committee to the City Council “whether the audited financial statements should be received and filed with the Council.”²

Draft Financial Statements

As explained in the next section, the review by the Audit Committee of the audited financial statements, in accordance with the Municipal Code, occurs “upon the issuance of the audit opinion.” However, once the audit opinion is issued, it is our recommendation that the only changes or revisions that should result in an audit opinion being withdrawn and re-dated are those that are material.³ Any suggestions or revisions that are not material can be taken under advisement by management and the outside auditor for consideration with respect to the next ensuing fiscal year’s audit. To significantly reduce the possibility that a material mistake or omission would be discovered by the Audit Committee subsequent to the release of the audit opinion, and to allow the opportunity for Audit Committee members to make suggestions regarding the Comprehensive Annual Financial Report (the “CAFR”)⁴, the Municipal Code was amended in two respects. First, up to two members of the Audit Committee may be appointed “to meet with City management and the outside auditor, together or separately, *prior to the completion of the audit*, to review and discuss the draft financial statements and the conduct of the audit.”⁵ Second, a member of the Audit Committee may be appointed by the Committee “to attend meetings of the Disclosure Practices Working Group at which the audited financial statements of the City are considered.”⁶

It would be prudent for the Audit Committee to exercise its authority to appoint members of the Committee to both review and discuss the draft financial statements and participate in those meetings of the Disclosure Practices Working Group (“DPWG”) at which the financial statements are discussed. This would greatly facilitate the review by the Audit Committee of the audited financial statements, would provide the opportunity to clarify or revise any text in the CAFR, would give comfort to the Audit Committee regarding the integrity and the thoroughness of the DPWG procedures, and would significantly reduce the possibility that a material mistake or omission would be discovered after the issuance of the audit opinion.

Review of Audited Financial Statements

Subsequent to any review and discussion by Audit Committee members with City management and the outside auditors of the draft financial statements and the conduct of the audit, and subsequent to the review by DPWG of the draft audited financial statements at DPWG

² San Diego Municipal Code, §26.1706(a)(6).

³ “In the context of financial reporting, the notion that an omission or misstatement of accounting information is of such significance as to make it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.” Definition of “materiality” provided in the Glossary to Stephen J. Gauthier, *Governmental Accounting, Auditing, and Financial Reporting* (Government Finance Officers Association, 2005).

⁴ The CAFR consists of the Letter of Transmittal, the Management’s Discussion and Analysis, the Basic Financial Statements, the Notes to the Financial Statements, the Required Supplementary Information, and the Statistical Section.

⁵ San Diego Municipal Code, §26.1706(b)(3) (emphasis added).

⁶ San Diego Municipal Code, §26.1706(b)(4).

meetings at which a representative of the Audit Committee may attend, the draft audited financial statements will be modified as appropriate and the final audit opinion will be issued.

Section 26.1706(a)(5)(A) provides that the Audit Committee:

shall review with the Chief Financial Officer and the outside auditor:

(A) the audited financial statements and the notes to the audited financial statements in the City's Comprehensive Annual Financial Report upon the issuance of the audit opinion and provide to the City Manager and the City Council any comments or recommendations it may have

It is our recommendation as General Disclosure Counsel that, at such time as the audit opinion is issued, the CAFR be posted promptly on the City's investor information webpage. Such posting would be accompanied by the cautionary note referenced in item 6 of the attached Exhibit A. The City's various contractual undertakings to post its CAFR on the EMMA system permit such posting to occur, in general, 240-270 days after the end of the City's fiscal year. However, the Securities and Exchange Commission, the rating agencies, and the financial analysts, have been urging municipal issuers to provide more timely financial information to the market, in a period not to exceed 150-180 days after the end of the fiscal year. It is in the best financial interests of the City and reflects best practices to provide its audited financial statements to the market once the audit opinion is issued. Recognizing, however, that, despite the precautions and care taken by management, the DPWG, the outside auditor, and members of the Audit Committee pursuant to Municipal Code §§26.1706(a)(3) and (4), there exists the possibility that the review of the audited financials by the Audit Committee pursuant to Municipal Code §26.1706(a)(5) and their receipt and filing by the Council could result in material revisions to the audited financials, we would recommend that they not be posted on the EMMA system until such time as they had been received and filed by the Council.

It should be noted that the City has potential federal securities law liability with respect to any financial disclosures that are "reasonably expected to reach investors and the trading markets."⁷ Certainly any financial disclosures that are posted on the City's investor information webpage are reasonably expected to reach investors (that is the very purpose of such webpage), and therefore the City has potential federal securities law liability for the audited financial statements once so posted. Nevertheless, as a result of the controls and processes outlined in this memorandum regarding the audited financial statements, it is very unlikely that once posted there would be a material mistake or omission. On balance, the interests of providing timely financial disclosure to the market weighs in favor of posting on the investor information webpage once the audited financial are available. We do not recommend, however, that the audited financials be transmitted to the EMMA system until they have been reviewed by the Audit Committee and received and filed by the Council.⁸ If there were to be a material

⁷ SEC Rel. Nos. 33-7049, 34-33741 (Mar. 9, 1994).

⁸ This memorandum does not address the situation in which management, DPWG, the outside auditor, the City Attorney, and the City's general disclosure counsel are in agreement that the audited financial statements are fair and accurate with no material

mistake or omission in the audited financial statements that are posted on the investor information webpage, such statements could be pulled and replaced. On the other hand, once the audited financials are posted on the EMMA system, any subsequent revisions would be in the form of a supplemental filing, which could be avoided if the posting is subsequent to receipt and filing by the Council.

Council Action

It is the responsibility of the Audit Committee, subsequent to its review of the audited financial statements with the Chief Financial Officer and the outside auditor, to “recommend to the City Council whether the audited financial statements should be received by and filed with the Council.”⁹ In doing so, the Audit Committee is authorized to “require certifications from any City employee regarding that employee’s role in preparing the City’s financial statements that the Committee deems necessary and appropriate to support the Committee’s recommendation to the City Council.”¹⁰

Conclusion

The recommendations in this memorandum are intended to balance the interests of the City in releasing its audited financial statements to the public once the audited financial statements are issued with the oversight responsibilities of the Audit Committee and the role of the City Council in receiving and filing the audited financial statements.

With the input of management, working with the outside auditor, draft financial statements will be produced that can be reviewed and discussed with any two members of the Audit Committee that are appointed by the Committee to participate in such process. DPWG will review such draft audited financial statements once submitted to it, and a member of the Audit Committee is further invited to participate in that process. Once management, the outside auditor, DPWG, and those members of the Audit Committee who participate in the reviews of the draft financial statements, are satisfied, the audit opinion will be issued. It is our recommendation that at such time the audited financial statements be posted on the City’s investor information webpage. The Audit Committee reviews the audited financial statements, and recommends to the City Council whether such statements should be received by and filed with the Council. Once that receipt and file process is complete, the audited financial statements would be posted on EMMA in fulfillment of the City’s contractual obligations.

mistakes or omissions, but either (i) the Audit Committee does not recommend that the City Council receive and file the audited financial statements or (ii) the City Council does not approve the receipt and filing of the audited financial statements.

⁹ San Diego Municipal Code §26.1706(a)(6).

¹⁰ San Diego Municipal Code §26.1706(b).

Process for Review and Posting of CAFRs

1. Prior to commencement of the audit for a fiscal year, the outside auditor, with financial management present to comment as necessary, will review the audit plan with the Audit Committee.
2. Approximately mid-way through the audit, the outside auditor and financial management should report to the Audit Committee the status of the audit and any significant issues or problems encountered.
3. It is understood that the outside auditor and financial management also are expected and encouraged to bring to the attention of the Audit Committee in a timely manner, separate from the foregoing, any significant matters regarding the audit of which the Audit Committee should be aware as part of its oversight responsibility.
 - a. Mun. Code §26.1706(a)(3) provides that the Audit Committee “may appoint up to two members of the Committee, in an ad hoc capacity, to meet with City management and the outside auditor, together or separately, prior to the completion of the audit, to review and discuss the draft financial statements and the conduct of the audit.”
4. The near final draft of the CAFR shall be provided to the DPWG for its review and comments. Upon completion of such review, DPWG shall certify in writing to the Audit Committee and the City Council that the DPWG has reviewed the CAFR in accordance with Mun. Code §22.4108(a)(1) and that in the best judgment of the DPWG the CAFR is in substantially final form.
 - a. Mun. Code §26.1706(a)(4) provides that the Audit Committee “may appoint a Committee member to attend meetings of the Disclosure Practices Working Group at which the audited financial statements of the City are considered.”
5. Upon completion of the audit and the related CAFR, including delivery of the outside auditor’s opinion, and following review by the DPWG, the CAFR, with related certifications, shall be provided to the Audit Committee and City Council for review at least two weeks prior to their taking action on the CAFR.
 - a. Mun. Code §26.1706(a)(5)(A) provides that the review by the Audit Committee shall be done “upon the issuance of the audit opinion”.
 - b. Thus, the Code contemplates review by the Audit Committee *after the executed audit letter is released*, and provides that upon such review the Audit Committee shall “provide to the [Mayor]

and the City Council any comments or recommendations it may have.”

c. It is the further intent of the Code, however, that by permitting ad hoc meetings of Audit Committee members with City management and the outside auditor, and attendance by an Audit Committee member at the DPWG meetings at which the draft audited financial statements are considered, that any significant concerns of one or more members of the Audit Committee will have been addressed before the audit opinion is finalized.

6. Upon receipt of the executed audit letter, at the same time that the CAFR is delivered to the Audit Committee for its review, it shall be posted on the City’s investor information webpage, with a cautionary note to the following effect:

“We have posted the City’s fiscal year [X] Comprehensive Annual Financial Report (‘CAFR’), which includes the City’s fiscal year [X] audited financial statements. Pursuant to disclosure controls and procedures adopted by the City, the CAFR is required to be approved by the City’s Audit Committee and received and filed by the City’s City Council. Those additional procedures of the Audit Committee and the City Council have not yet occurred, and were they to result in any material changes to the CAFR, such changes will be highlighted in a subsequent posting. In addition, at such time as the additional procedures of the Audit Committee and the City Council have been completed, the City will file the fiscal year [X] CAFR with EMMA (the Electronic Municipal Market Access system maintained by the Municipal Securities Rulemaking Board).”

7. At a meeting of the Audit Committee at least two weeks after being provided the CAFR, the CAFR will be discussed, with the Audit Committee asking questions of financial management and the outside auditor along the lines of those attached as Exhibit A. If the Audit Committee is satisfied, it will approve a motion recommending to the City Council receipt and filing of the CAFR.

8. At a meeting of the City Council some time after the Audit Committee meeting, with financial management and the outside auditor available to answer questions, the City Council will be asked to approve a motion to receive and file the CAFR.

9. Upon receipt and filing of the CAFR by the City Council, the CAFR will be transmitted to EMMA in satisfaction of the City’s various continuing disclosure agreements.

San Diego Audit Committee

Key Documents

- City Charter, Article V, Section 39.1, Audit Committee
- Municipal Code
 1. Chap. 2, Art. 2, Div. 41: Securities Disclosure (DPWG)
 2. Chap. 2, Art. 6, Div. 17: Audit Committee
- Memorandum from Hawkins to Kevin Faulconer, dated Mar. 18, 2011: “Further Delayed Release of the FY 10 Audit”
- Memorandum from Hawkins to Kevin Faulconer, dated Nov. 23, 2010: “Delayed Release of the FY 10 Audit; Federal Securities Law Implications”
- *Third Annual and Final Report of the Independent Consultant to the City of San Diego*, dated Feb. 24, 2010
- Letter from Stan Keller to Kevin Faulconer, dated Mar. 31, 2009, re “completion of the audit and review by the Audit Committee prior to submission to the City Council”
- Memorandum from Hawkins to Audit Committee, dated Mar. 21, 2009: “Filing/Posting of 2008 CAFR”
- Memorandum from Brant C. Will (Deputy City Attorney) and John M. McNally (outside Disclosure Counsel) to City Council, dated July 9, 2008: “Federal Securities Law Responsibilities re Review of Disclosure Documents”
- Audit Committee, CAFR Review Questions (as revised June 23, 2008)
- Letter from City Attorney to Audit Committee, dated June 6, 2008: “Audit Committee Review of Comprehensive Annual Financial Reports: Formal Questioning.”
- Letter from Stan Keller to Kevin Faulconer, dated May 28, 2008, re “observations regarding several reports recently provided to the Audit Committee”
- *Report of the Ad Hoc Citizens Advisory Committee to the Audit Committee*, dated Apr. 28, 2008

- Jefferson Wells, *Report to the City of San Diego Audit Committee*, dated Apr. 21, 2008
- Memorandum from Hawkins to Audit Committee, dated May 14, 2007: “Federal Securities Law Responsibilities re Review of 2003 CAFR”
- Letter from City Attorney to Audit Committee, dated Feb. 7, 2007: “Responsibilities of the Audit Committee Under Federal Securities Laws”