

To the Honorable Mayor and City Council
of the City of San Diego
San Diego, California

**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***

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of San Diego, California (the "City"), as of and for the year ended June 30, 2010, which collectively comprise the City's basic financial statements and have issued our report thereon dated August 31, 2011. Our report includes a reference to other auditors and an explanatory paragraph describing the City's implementation of new accounting standards effective July 1, 2009. 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. Other auditors audited the financial statements of the San Diego Housing Commission and the Southeastern Economic Development Corporation, as described in our report on the City's basic financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the City's internal control over financial reporting 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 City's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the City's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying schedule of current year findings, we identified a deficiency in internal control over financial reporting that we consider to be a material weakness and another deficiency that we consider to a significant deficiency.

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. We consider the deficiency described in the accompanying schedule of current year findings as item 2010-(b) to be a material weakness.

A *significant deficiency* is a deficiency, or 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. We consider the deficiency described in the accompanying schedule of current year findings as item 2010-(a) to be a significant deficiency.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the City's financial statements are free of 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 determination of financial statement amounts. 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 an instance of noncompliance or other matters that is required to be reported under *Government Auditing Standards* and which is described in the accompanying schedule of current year findings as item 2010-(c).

The City's responses to the findings identified in our audit are described in the accompanying schedule of current year findings and prior year findings. We did not audit the City's responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the City Council, Mayor, the City's audit committee, City management, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Macias Jini & O'Connell LLP
San Diego, California
August 31, 2011

CITY OF SAN DIEGO
Schedule of Current Year Findings
For the Year Ended June 30, 2010

Financial Statement Findings:

Finding No. 2010 - (a) SAP/HCM Module Implementation Resulted in Processing Errors

Observation – Appropriate general IT controls should ensure that a system implementation is configured to provide accurate and complete data and information results. The City’s SAP/HCM module implementation initially contained configuration errors in the distribution of employee costs among the City funds and departments. There were several causes for the initial configuration errors, including; incomplete configuration definitions being communicated to the project implementers, incomplete post-implementation testing, absence of production sign-off by business users after the first completed business cycle, and incomplete preparation of testing scenarios prior to the system go-live. While City IT and Comptroller staff identified the errors in processing and after considerable time and effort resolved the processing configuration issues, the City’s FY 2010 and a portion of FY 2011 payroll transactions had to be re-processed leading to a delay of the FY 2010 audit cycle.

Recommendation – In future implementation projects, the City IT department, working with the functional user department’s business process coordinator, should designate an individual to be responsible for ensuring that oversight of the project implementation is documented and complete per the City’s OneSD Functional Change process.

Response – The City agrees with this recommendation and it has already been implemented. The OneSD Functional Change process referenced in the recommendation was implemented in February 2010 and continues to be part of the City’s IT control structure. The oversight of the process as applied to ongoing support functions is already performed by staff in the City’s ERP Department, and the scope of the oversight has been extended to include new/future SAP projects.

The controls included in the Functional Change process include Business Process Coordinator (BPC) wet signature approval of all functional specifications before development work begins, documented testing results of the program change, and BPC authorization to move changes to the production environment. The controls listed above are reviewed for accuracy and completeness during a formal Change Control meeting, prior to the change being approved by the ERP Department for deployment to production. After the change has been implemented in production, the BPC validates the change is working as desired in the production environment.

During future projects, all implementation software and code, as well as subsequent break/fix changes, enhancements, and design changes, will be subject to the Functional Change process with oversight by the ERP Department.

Using the 2010 Functional Change process during project implementation and continuously throughout production deployment, bug/fix, and in on-going support scenarios will ensure a situation similar to the processing errors identified in this finding will not occur in the future.

Finding No. 2010 - (b) Schedule of Expenditures of Federal Awards (SEFA)

Observation – While conducting our audit of the City’s financial statements and testing of the SEFA, we noted that the City did not properly include \$3,858,257 in federally reimbursed expenditures associated with the Capitalization Grants for Clean Water State Revolving Funds (CWSRF) program (federal catalog number 66.458) in the proper accounting period.

CITY OF SAN DIEGO
Schedule of Current Year Findings (Continued)
For the Year Ended June 30, 2010

The City received reimbursement in FY 2006-07 from the State Water Resources Control Board (SWRCB) for expenditures incurred during FY 2002-03 through FY 2004-05 related to the Point Loma Fourth Sludge Pump Modifications project. Due to the timing of the approved loan agreement between the City and SWRCB, which occurred in November 2006, and subsequent reimbursement of expenditures, the City should have reported the \$3,858,257 in federally reimbursed expenditures in its SEFA for the year ended June 30, 2007. As a result, the CWSRF program was considered a major federal award program pursuant to Office of Management and Budget (OMB) Circular A-133 during FY 2009-10, as opposed to FY 2006-07, when the City received the federal funds from the SWRCB and should have reported the program in the SEFA.

Recommendation – During the compilation and preparation of the SEFA, we recommend the Comptroller’s Office perform a reconciliation between the federal expenditures incurred and reported in the SEFA, to the federal revenues and/or cash receipts recognized during each fiscal year. Performing such a reconciliation should identify potential timing differences between the receipt and recognition of federal revenues and expenditures related to federal award programs.

Response – The City agrees with this recommendation and has implemented corrective measures. Specifically, the business department has been instructed to notify the Comptroller’s office upon receipt of approved loan agreements between the City and the SWRCB. The Comptroller’s office will reconcile the federal expenditures and revenues on an annual basis for presentation in the SEFA schedule.

Compliance Finding:

Finding No. 2010 - (c) Continuing Annual Disclosure Requirements

Observation – Due to the delays in the year-end closing process resulting from the City’s newly implemented ERP system, the City did not submit its June 30, 2010 audited financial statements to the Electronic Municipal Market Access (EMMA) system within the required time frame (generally 270 days after year-end), as the audited financial statements were not issued until August 2011. The City was therefore, not in compliance with its continuing disclosure contractual obligations for the fiscal year ended June 30, 2010.

Recommendation – In the future, if the City anticipates not having the ability to satisfy its continuing disclosure requirement to file audited financial statements by the 270 day period after fiscal year-end, in consultation with the City’s Disclosure Practices Working Group and reviewing the circumstances behind the delay, management should consider filing unaudited financial statements, if available, until such time that the audited financial statements can be filed. The continuing disclosure agreements and securities laws provide for the interim filing of unaudited financial statements.

Understanding that the reason for not satisfying the continuing disclosure requirements was due to a one-time delay related to the ERP implementation, this should not be an ongoing compliance finding for the year ended June 30, 2011.

Management Response – The City agrees with this recommendation. Even though future delays are not expected, the City will assess the availability of unaudited financial statements leading up to the continuing disclosure filing dates in the event of a delay of the audited financial statements.

CITY OF SAN DIEGO
Schedule of Prior Year Findings
For the Year Ended June 30, 2010

Findings related to the Financial Statements:

Reference Number:	2009-(a)
Topic	Risk Management – Public Liability
Audit Finding	The City’s internal controls over public liability reserves require the completion and authorization of a “Request for Action” form (RFA) by a claims adjuster documenting the rationale whenever an adjustment is required. In addition, changes in reserve amounts above \$100,000 are required to be reviewed and approved by a supervisor or manager. During our testing of internal controls, we noted eight (8) out of forty-five (45) transaction selected for testing where the RFAs did not indicate the rationale for the reserve adjustment, nor was there any indication that management had reviewed or authorized any of these RFAs. This is a repeat finding from the prior two (2) fiscal year audits.
Status of Corrective Action	Implemented and corrected – Results of our current year testing of 45 transactions resulted in no findings.
Reference Number:	2009-(b)
Topic	Risk Management – Expenditure Accruals
Audit Finding	During the testing of internal controls over the City’s Risk Management department’s cash disbursements related to claims liabilities, we noted that two (2) out of forty-five (45) transactions selected for testing were for services rendered in fiscal year 2008. These services were for outside legal counsel related to claims and judgments. These expenditures should have been recognized (accrued) when incurred in fiscal year 2008.
Status of Corrective Action	Implemented and corrected – Results of our current year testing of 45 transactions resulted in no findings.
Reference Number:	2009-(c)
Topic	Timely Capitalization of Donated Capital Assets from Developer Contributions
Audit Finding	During the performance of our testwork over donated capital assets, we noted that fifty-seven (57) out of one hundred and fifty-four (154) donated assets that were capitalized in fiscal year 2009 were actually donated in and should have been capitalized in prior fiscal years (2006-2008).
Status of Corrective Action	Implemented and corrected – Results of our current year testing identified contributions of capital assets were recorded in the proper accounting period.

CITY OF SAN DIEGO
Schedule of Prior Year Findings (Continued)
For the Year Ended June 30, 2010

Reference Number:	2009-(d)
Topic	Land Held for Resale Documentation
Audit Finding	During the testing of internal controls over the Redevelopment Agency's (Agency) additions to property held for resale, we noted that for one (1) out of four (4) transactions selected for testing, the Agency could not provide the supporting documents to verify reasonableness of the historical value. The property was originally acquired as a capital asset prior to 1980, reported in the Agency financial statements as land, and transferred to property held for resale during fiscal year 2009.
Status of Corrective Action	Corrected – The Agency has implemented the corrective action and all additions are properly documented and the supporting transactions are added to the land held for the resale and capital assets permanent folder.

Reference Number:	2009-(e)
Topic	Electronic Data Processing General Controls
Audit Finding	During the electronic data processing review, the following findings were observed: <ul style="list-style-type: none"> a. There is no formal policy and associated procedures in place to ensure that system and application access is rescinded for inactive users. The policy and associated procedures should state and ensure that system and application access is removed as part of the separation procedures for employees from the City. b. There is no formal policy and associated procedures in place to ensure all system and application access rights are up-to-date and at an appropriate level to enforce a proper segregation of duties. c. All transactional data is currently stored within the City's core financial management application, AMRIS. As the amount of data stored within the core financial management system increases, system performance may be adversely affected.
Status of Corrective Action	<ul style="list-style-type: none"> a. Corrected – The City formally adopted Administrative Regulation 90.63, Information Security Policy, which specifies that all department and City computer system privileges must be promptly terminated at the time a user leaves City employment or ceases to provide services to or receives services from the department or the City. The termination of access must occur as soon as possible and no more than three business days after access is no longer required.

CITY OF SAN DIEGO
Schedule of Prior Year Findings (Continued)
For the Year Ended June 30, 2010

- b. Corrected – Along with the SAP system, the City implemented a robust set of authorization roles that define specific transactions that can be conducted by individual employees. The City also implemented both access and process controls that identify segregation of duty issues in the authorization roles as well as in the actual transactions conducted by employees. Additionally, Administrative Regulation 90.63, Information Security Policy, specifies that user accounts shall be reviewed at least annually.
- c. Corrected – With the implementation of the City’s SAP system, AMRIS is no longer used for transactional processing.

Reference Number:	2009-(f)
Topic	Continuing Annual Disclosure Requirements
Audit Finding	During the performance of our testwork over continuing annual disclosure requirements, we noted that the Redevelopment Agency of the City of San Diego (Agency) did not submit one (1) out of the thirty-five (35) required Annual Reports for fiscal year 2008 to the Electronic Municipal Market Access (EMMA) within the required time frame, generally 270 days after year-end.
Status of Corrective Action	Corrected – The Agency prepared and submitted the required Annual Report for fiscal year 2009 and 2010 to the EMMA within the required time frame.

Reference Number:	2003-1
Topic	Material Weakness in Internal Controls over the Financial Reporting Process
Audit Finding:	There were inadequate policies, procedures, internal controls and personnel to ensure the preparation of an accurate and reliable CAFR on a timely basis. Specifically, deficiencies were noted in the following areas: CAFR Preparation; Pension Accounting; Capital Asset Accounting; Metropolitan Wastewater Utility; Risk Management; City Treasurer’s Cash and Investment Pool; Procurement; Accounts Payable and Accrued Expense; Human Resources; Accounts Receivable; Information Technology. As a result of this, numerous material corrections to the CAFR for the year ended June 30, 2003 in the amount of \$1 billion were proposed and booked.

CITY OF SAN DIEGO
Schedule of Prior Year Findings (Continued)
For the Year Ended June 30, 2010

Status of Corrective Action Corrected -The implementation of OneSD has improved the year-end financial reporting process. During the year ended June 30, 2010, there were no adjustments identified that resulted in material misstatements related to the City’s Comprehensive Annual Financial Report (CAFR).

Reference Number: **2003-4**

Topic Violations of Securities Laws

Audit Finding In November 2006, the Securities and Exchange Commission (SEC) entered an Order sanctioning the City of San Diego for committing securities fraud by failing to disclose to the investing public important information about its pension and retiree healthcare obligations. To settle the action, the City agreed to cease and desist from future securities fraud violations and to retain an independent consultant for three years to foster compliance with its disclosure obligations under the federal securities laws.

In issuing the Order, the SEC made the following determinations:

- The City failed to disclose the City’s unfunded liability to its pension plan, which was projected to dramatically increase.
- The City failed to disclose that it had been intentionally underfunding its pension obligations so that it could increase pension benefits but defer the costs.
- The City knew or was reckless in not knowing that its disclosures were materially misleading.
- The City made these misleading statements through three different means:
 - The City made misleading statements in the offering documents for five municipal offerings in 2002 and 2003 that raised over \$260 million from investors. The offering documents included offering statements.
 - The City made misleading statements to the agencies that gave the City its credit rating for its municipal bonds.
 - The City made misleading statements in its “continuing disclosure statements”, which described the City’s financial condition.

CITY OF SAN DIEGO
Schedule of Prior Year Findings (Continued)
For the Year Ended June 30, 2010

Status of Corrective Action

Corrected – The City consented to the SEC Order and as part of the applicable remediation, the City retained an independent consultant to monitor the City’s compliance with and remediation of the issues identified in the Order. The City’s response to this finding has been a combination of staffing changes, modified policies and procedures along with system improvements to correct the internal control weaknesses that contributed to the materially misleading disclosures. Furthermore, the City established an Audit Committee of the City Council and a Disclosure Practices Working Group (DPWG). The DPWG is responsible for reviewing the City’s annual financial statements to ensure that all material items are appropriately disclosed and reported in the City’s CAFR. The independent consultant has reported on the City’s progress with respect to several remediation issues from the SEC Order. The 2008 Annual Report of the Independent Consultant to the City of San Diego (Report) was dated March 25, 2008, the 2009 Report was dated April 24, 2009, and the 2010 Report was dated February 24, 2010; all of the reports are available.