



THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: January 30, 2012

IBA Report Number: 12-06

Rules Committee Docket Date: February 1, 2012

Item Number: 3

Amending Council Policy 700-10 to Implement City Auditor Recommendation Regarding Audit Authority for City Leases

OVERVIEW

City Council Policy 700-10 (Attachment 1), entitled Disposition of City-Owned Real Property, establishes procedures for the management of City-owned real estate. More than half of Council Policy 700-10 is devoted to establishing policies that govern most of the City's property leases. On page 11 of the Policy, Section P addresses audits for City leases specifying that "All percentage leases shall be audited by the City Auditor and Comptroller in the first year of operation to establish proper reporting procedures and at least once every three (3) years thereafter." The Policy was last amended on October 17, 2008.

In Fiscal Year 2008, management restructured/moved the positions responsible for performing revenue compliance audits of City leases, hotels and franchises from the City Auditor and Comptroller Department to the Office of the City Treasurer. The City Treasurer established a Revenue Audit Program (RAP) within her department with these positions. In Fiscal Year 2009, the City Auditor and Comptroller Department was renamed to become the City Comptroller's Department and a separate, independent Office of the City Auditor was established.

The aforementioned restructuring (the creation of an independent Office of the City Auditor) was part of Proposition C, approved by the voters in June of 2008. The reorganization resulted in Council Policy 700-10 referring to a department (City Auditor and Comptroller Department) that ceased to exist in Fiscal Year 2009. The Office of the City Auditor audited lease revenues as part of its comprehensive Citywide Revenue Audit (March 2010) and raised the following question with regard to the City's revenue compliance auditing:

“The question that arises from Council Policy 700-10 is where auditing authority lies now that the City Auditor’s Office and the City Comptroller’s Office are separate entities. Moreover, while lease agreements do not generally state which entity within the City is responsible for auditing the lessee, the Revenue Audit Division does not lie within the City Auditor’s Office or the City Comptroller’s Office.”

In developing its audit recommendations relating to City leases, the City Auditor suggested the IBA work with the Real Estate Assets Department (READ) to revise Policy 700-10 and clarify auditing authority. More specifically, recommendation #16 from the Citywide Revenue Audit indicates:

“The Office of the Independent Budget Analyst (IBA) should work in consultation with the Real Estate Assets Department to revise Council Policy 700-10 to clarify who has the appropriate auditing authority.”

FISCAL/POLICY DISCUSSION

The delay in addressing recommendation #16 was in part the result of ongoing discussion at Council Committees and with the Office of the City Attorney about whether RAP functions are appropriately located in the Office of the City Treasurer or whether they should/could be moved to the Office of the City Auditor. On March 17, 2010, the Budget and Finance Committee requested the IBA analyze considerations surrounding a proposal to transfer RAP to the Office of the City Auditor and report back to the Audit Committee. The Audit Committee also requested this analysis at its meeting on April 12, 2010. In performing the analysis, the IBA discussed the matter extensively with the City Treasurer, City Auditor and the City Attorney’s Office, analyzed RAP revenue recovery data over several years and contacted 11 cities to determine where this function resided in their organizations.

IBA Report #10-39 (Attachment 2) was subsequently presented to the Audit Committee on May 10, 2010. While our research did not identify a single best practice as to where this function should be located, we ultimately concluded:

“The IBA believes that a determination as to where the revenue compliance audit function is located within the organization should be based solely on operating efficiency and effectiveness. The City’s current organizational structure for this function is similar to that of almost all major cities. We would suggest a recommendation to transfer the RAP only be made if the Audit Committee is convinced that the City Auditor can develop and realize significant operating efficiencies that could not otherwise be achieved by the Office of the City Treasurer.”

Our report further recommended that the Audit Committee request an opinion from the Office of the City Attorney regarding any legal implications related to such a transfer. At its meeting on May 10, 2010, the Audit Committee requested analysis from the Office of the City Attorney related to the legality of the City Council transferring the RAP functions from the Office of the City Treasurer to the Office of the City Auditor. On June 10, 2010, the Office of the City

Attorney issued a Memorandum of Law dated June 10, 2010 (within Attachment 3) in response to this matter and presented it to the Audit Committee. With respect to the contemplated transfer of the RAP, the City Attorney's Memorandum of Law concluded:

“The City Council may not legally transfer the functions of the Revenue Audit Division of the City Treasurer (Treasurer) to the City Auditor's Office. San Diego Charter section 45 places an express duty on the Treasurer to maintain a continuous inspection over special revenues she must collect from businesses, in order to effectuate collection of the revenue. The Treasurer meets this Charter duty through the Revenue Audit Division, which conducts periodic inspections of the records of businesses which remit the special revenues to the City, to ensure the revenues remitted are correct. The Treasurer is part of the City's financial management and reporting structure. The collection of revenue is a management function.

The independent City Auditor was established in 2008 by Charter section 39.2. The City Auditor is tasked with auditing City departments and offices to provide the public and City officials with objective, nonpartisan assessment of the stewardship, performance, or cost of the City's policies, programs and operations. To ensure independence from management, the City Auditor reports to the Audit Committee. A transfer to the City Auditor of a management (collection-of-revenue) function, which the Auditor must audit, conflicts with the Charter and Government Auditing Standards' requirements for Auditor independence.”

In 2011, the City Auditor asked the Office of the City Attorney to revisit the analysis contained in its June 10, 2010 Memorandum of Law. The Office of the City Attorney obliged and issued memoranda dated August 12, 2011 (within Attachment 3) and September 15, 2011 (Attachment 3). In the memorandum to the Audit Committee dated September 15, 2011, the Office of the City Attorney provided:

“A few months ago, the Auditor asked us to revisit our 2010 analysis and conclusions in that MOL. In response, we prepared a memorandum dated August 12, 2011, which concluded that our 2010 opinion remained the same. The Revenue Audit Division of the City Treasurer may not be transferred to the City Auditor. However, the memo further provided that the Auditor does have the authority to audit the Revenue Audit Division of the Treasurer's Office.”

CONCLUSION

Considering the recently reaffirmed June 10, 2010 Memorandum of Law and requests from the Real Estate Assets Department to address outstanding Citywide Revenue Audit recommendation #16, the IBA is recommending a simple amendment to Section P of Council Policy 700-10. The proposed amendment (shown in a strikeout/underline format on page 11 of Attachment 1) substitutes "City Treasurer" for "City Auditor and Comptroller". The proposed change addresses Citywide Revenue Audit recommendation #16 and reflects current City practices.

The Real Estate Assets Department has informed the IBA that the rest of Council Policy 700-10 requires no further amendment at this time.



Jeff Kavar
Fiscal & Policy Analyst



APPROVED: Andrea Tevlin
Independent Budget Analyst

Attachments: 1. Council Policy 700-10 (proposed amendment in strikeout/underline format)
2. IBA Report #10-39 dated May 7, 2010
3. Office of the City Attorney Memorandum dated September 15, 2011

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

SUBJECT: DISPOSITION OF CITY-OWNED REAL PROPERTY
POLICY NO.: 700-10
EFFECTIVE DATE:

BACKGROUND:

The City of San Diego is owner of substantial real property which is used for various municipal purposes. As public service needs change, the requirements for these properties may be revised and, on occasion, certain parcels may be in excess of the City's current need. This requires that each individual site be reviewed in terms of its potential for future public use, as well as its potential economic benefit to the City.

The proceeds from the sale of City-owned lands are utilized for Capital Improvements Program projects, as required by the City Charter, Section 77, and the revenues generated from leases are normally utilized for General Fund purposes unless the property sold or leased belonged to an Enterprise Fund.

PURPOSE:

It is the purpose of this policy 1) to establish a procedure by which unused and marginally used City-owned real estate is reviewed for its potential public use, and for designating unneeded parcels for lease or sale; 2) to provide methodology for the sale or exchange of City-owned real estate and 3) to establish policies for the leasing of City-owned real property.

POLICY:

It is the City's policy to manage its real estate assets so that municipal needs which rely on these assets may be properly implemented. It is not the City's policy to speculate in real estate. The Mayor will review City-owned real estate not used for municipal purposes and determine the appropriate use of the property. Those properties not needed for either City or public use within the foreseeable future, may be made available for lease or sale.

The City shall optimize the sale price or lease rent from City-owned real estate based on relevant factors, including 1) an appraisal reflecting current market value when either a transaction or authorization to sell or lease is presented to the City Council, 2) prevailing economic conditions and market trends, and 3) any special benefits to accrue from the sale or lease. The City shall seek market value for its properties. Discounts will not be negotiated unless an extraordinary need or circumstance is recognized by Council Resolution setting forth the amount of the discount and the justification for the discount.

The Real Estate Assets Department shall prepare and present to the City Council a comprehensive Portfolio Management Plan on an annual basis, with periodic reviews and as-needed updates at City Council Committee. The Portfolio Management Plan shall include an overall review of the City's real estate portfolio (or inventory), an operating plan for corporate property, a disposition plan for

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

surplus property, market research to support anticipated transactions and a request for authority to act within defined parameters (as described in this policy).

The major elements of the Portfolio Plan are to include:

- Property evaluation and characterization of real estate assets
- Strategy for City occupied real estate
- Investment Portfolio Plan (Leases to for-profit tenants)
- Review of Not-for-profit leases
- Disposition Plan for surplus assets
- Business Case development review to support proposed transactions
- Legal document development and review

POLICY REVIEW:

Revised Council Policy 700-10 shall be reviewed by the City Council for effectiveness one year after adoption and periodically thereafter as needed.

SALE OF CITY OWNED REAL ESTATE**PROCEDURE:****A. Real Estate Review**

As part of an overall portfolio management plan for the City's real estate assets, the Mayor's staff will review the City's property inventory to determine which properties are no longer needed for public facilities or to support the elements of the General Plan and whose disposition will provide a greater public benefit. A City owned property may become available for sale if:

- The property is not currently used by a City department or does not support a municipal function.
- The property is vacant and has no foreseeable use by the City.
- The property is a non-performing or under-performing asset and greater value can be generated by its sale.
- Significant economic development opportunities can be generated by selling the property.

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

Factors to be considered in determining whether a property should be sold include:

- Will the City be relieved of potential liabilities and/or cost of maintaining property that does not generate income or provide public benefit?
- Property tax increment that will be created by returning the properties to the tax rolls.
- Stimulation of the economy by providing opportunities for private sector investment.
- Generation of revenue for the Capital Outlay Fund or an Enterprise Fund.
- The sale of the property will generate greater economic value than a ground lease, if a ground lease is a feasible option.

B. Governmental Clearance Process

Government Code Section 54222 requires that a local agency proposing to dispose of surplus property must first notify all governmental agencies operating within the City as to the availability of the property. The agencies are given 60 days to respond with an intent to acquire, if not, the property may be deemed cleared for public sale.

Regarding the list of properties for sale:

- Governmental agencies are regularly contacted as the surplus list is updated.
- City departments, Park & Recreation, Fire, Police, Libraries, MWWD, Planning, Engineering and Capital Projects and Water are individually contacted as the surplus list is updated.
- Council offices are given a preliminary review to allow council staff to comment on foreseeable uses for the property.

C. Approval Process

- City-owned properties that have been identified by the Mayor as candidates for sale will be presented to Council for approval to be sold. If a property is of a type and location that would make a ground lease feasible, an economic analysis of the benefits of lease vs. sale will be conducted.
- If Council determines that the property may be sold, it shall authorize the Mayor to sell the property for a price equal to or greater than a minimum price established by a current (less than six month old) appraisal. The authorization to sell the property will be valid for twelve months from the date of Council action.
- The Mayor or his designee may enter into purchase and sale agreements, close escrows and execute and deliver grant deeds to the purchasers of the properties at prices equal to or greater than the minimum price approved by Council at terms and conditions deemed reasonable, and in the City's best interests, by the Mayor or his designee.

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

- The Mayor will report out on the price, terms and conditions of all transactions.
- Properties that cannot be sold at a price equal to or greater than the minimum price approved by Council will be returned to Council for further consideration prior to their disposition. Council approval will be required to sell a property at a price less than the minimum price previously approved by Council.

D. Method of Sale

Properties may be sold by any method allowed by Council Policy and Municipal Code. This includes direct negotiation, request for proposal, listing with a broker, sealed bid, auction or other appropriate method as determined by the Mayor. Possible method of sale for all properties will be included in the enabling resolution authorizing their sales.

E. Marketing

Properties offered for sale shall receive the widest possible exposure to the open market place. This may be accomplished through direct marketing techniques, such as requests for proposals (RFPs), advertising, exposure through the real estate media, posting the property on the multiple listing service or any other appropriate method. When appropriate, properties may be listed for sale with qualified real estate brokers. The authorization to utilize the services of a real estate broker will be contained in the enabling resolution.

F. Real Estate Brokers

Real estate brokers may be used to represent the City in the sale of its properties. Brokers will be selected for individual assignments through Requests for Proposals (RFP) or Requests for Qualifications (RFQ) and a subsequent bid or other methods that result in the City receiving the services of a qualified broker at the best value to the City. The maximum approved commission rate will be contained in the enabling resolution for the property's sale. If the property is listed with a broker, the City reserves the right to exclude from the listing agreement potential buyers whose interest in purchasing a subject property has been made a part of the record prior to the execution of such agreement. All brokerage participation and brokerage fees shall comply with Municipal Code Section 22.0905, Broker's Fee and Registration.

G. Exclusively Negotiated Sales

It will be the City's policy to insure the highest price for its real estate by pursuing open market transactions. However, on certain occasions, an exclusively negotiated sale may be

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

justified. Negotiated transactions shall comply with the requirements of Municipal Code Sections, as applicable, and may be approved under one of the following conditions:

1. When a parcel is landlocked.
2. When the sale to a contiguous owner would correct a site deficiency.
3. When a fee interest in a pipeline or other right-of-way is no longer required, it may be sold to a contiguous owner. A restrictive pipeline easement of adequate width or other required easements will be reserved from said sale.
4. When other governmental, public and quasi-public agencies submit acquisition proposals, a sale may be consummated per Municipal Code Section 22.0907, Sales of Real Properties to Public Agencies. These agencies shall include but not be limited to: Federal, State, and County agencies; school districts, special districts, and regulated utility companies.
5. When qualified nonprofit institutional organizations offer to purchase City-owned land, a negotiated sale may be consummated at fair market value providing there is 1) a development commitment, and 2) a right to repurchase or a reversion upon a condition subsequent. Institutional organizations such as churches, hospitals, extended care facilities, private schools and community service organizations are required to develop under the City's conditional use permit procedure.
6. When a property has been offered by public auction and no acceptable bids were received, it may be sold on a negotiated basis to any applicant submitting an acceptable offer within six months following the date of auction.
7. Real property exchanges may be consummated by direct negotiation per Municipal Code Section 22.0904, Exchanges of Real Property. However, exchanges will be considered only with other governmental agencies or when there is an advantage to the City.

H. Rezoning

Prior to completion of the sales transaction, City land shall be considered for rezoning in accordance with the General Plan, existing community plans or other City Council direction if a higher sale price will result. Also, all unnecessary easements affecting title to the property shall be removed if this will result in a commensurate increase in value.

I. Easements

The City will receive current fair market value for the removal of restrictive easements or access rights previously paid for by the City or other governmental agency or reserved in a sale of City property.

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY**J. Priority Handling**

Since time is of essence in land transactions, all such actions by Council and Committee shall be given the highest priority and special handling. Such action which must first go before a Council Committee will be placed on an early portion of the Committee agenda in order to assure prompt action. Subsequent to the Committee action, the item shall be placed on the docket of the next regular City Council meeting as a Supplemental Item.

K. Public Utilities Installed by Private Entities

The applicant for the use of unimproved City land for public purposes, such as streets, sewers, and other public utilities, shall compensate the City for the fair market value of the rights to be granted by the City. The amount of compensation shall be established by appraisal. However, lands which have been conveyed to the City after July 18, 1983, by private entities shall at the option of the grantor carry a reservation to the grantor for a period of 10 years following the date of conveyance to the City which would permit the grantor to install public utilities serving the grantor's adjacent land without the payment of compensation to the City therefore, and provided further that such installations shall not adversely affect any prospective use of the City's property. Persons who grant property to the City without charge shall have an automatic right to have such public service easements set aside on the donated property in the above manner.

LEASING OF CITY-OWNED REAL PROPERTY

The City of San Diego has a very diverse real estate portfolio. While the policies below are to act as the standard that governs most leases, the City acknowledges that parts of its leasing portfolio, such as Balboa Park, Mission Bay Park, Non-Profit organizations, Agricultural lands, Airports and Telecommunication Sites have specialized needs or restrictions. In these cases, Council Policy 700-10 will act as a framework for a sub-policy that will govern a specific area. Should a conflict arise between the framework policy and the sub-policy, the sub-policy will govern.

A. Criteria for Leasing

City property shall be considered for leasing when one or more of the following criteria apply:

1. The property is not required for current municipal use, but is to be held for possible future use and can be leased as an interim measure.
2. The property can only be leased because of legal restraints. For example, property held under Tideland trust grants or as dedicated parks.
3. The City requires substantial control over development, use and reuse of the property.

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

4. The property has the immediate potential of a high return to the City because of its high demand and type of use, such as commercial and industrial land.
5. The property can be efficiently utilized by a provider of services needed by the City.
6. The property can be leased to promote a substantial economic development opportunity.

B. Portfolio Management Plan

The Mayor may execute lease transactions that meet the terms of the City's asset strategy for a particular property previously approved by City Council in an overall Portfolio Management Plan. Negotiated transactions that fall outside of the parameters of an approved Portfolio Management Plan either will be submitted individually for City Council approval, or deferred until the next periodic update and approval of the plan.

C. Lessee Selection for New Leases

Competitive offers for lease of City property shall be solicited from the open market place. This may be accomplished through a number of marketing techniques, such as Request for Proposals (RFPs) – Council Policy 700-41, a marketing subscription system, direct advertising, use of a Multiple Listing Service (MLS), listing with a broker, posting the property and any other appropriate means.

In certain limited situations, the City may exclusively consider a single proposal for lease of City property. Potential lessees wishing to exclusively negotiate with the City must submit for City staff review a business case with sufficient justification as to how it is capable of optimizing the use of the property and return to the City, thereby negating the need for a competitive process. This information will be included when the lease transaction is presented for City Council approval.

Leasehold proposals shall be evaluated in terms of:

1. The degree to which the proposed use is in compliance with the City's strategic plan for the property.
2. In terms of the amount of consideration offered in the form of rent.
3. In terms of the financial feasibility of the proposal.
4. The capability, expertise and experience of the potential lessee with respect to the proposed leasehold development and operation.

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

5. If new development is proposed, a development plan that includes a description of the development team and its qualifications.
6. The details of each person or entity that will have an interest in the proposed lease to satisfy the requirements of City Charter §225.
7. Special public benefits to be derived (if any).

D. Rate of Return

The City shall obtain fair market rents for its leases commensurate with the highest and best use of the property. The fair market rent shall be based on an appraisal that complies with the definition of Market Rent found in the Uniform Standards of Professional Appraisal Practice (USPAP) published by the Appraisal Foundation. The appraisal shall be no more than six months old at the time the lease transaction is presented for City Council approval. If the cost of an appraisal is not justified by the anticipated rents, the City may choose an alternative method to establish rent. City leases shall contain terms and conditions which will sustain a fair rate of return throughout the duration of the lease.

E. Rental Terms

Rental terms may be negotiated on the basis of fixed rates (flat rent leases) or percentages of the lessee's gross income derived from business conducted on the property, with a provision for a minimum rental (percentage leases).

F. Percentage LeasesMinimum Rent

The minimum rent component for a new percentage lease shall be set at no less than eighty percent (80%) of the fair market rent as defined above. In certain cases, a portion of the minimum rent may be abated for new construction or redevelopment on the leasehold. The minimum rent shall be adjusted upward throughout the duration of the lease at intervals of not more than every five (5) years to reflect no less than eighty percent (80%) of the average annual rent actually paid or accrued during the three (3) years preceding the adjustment. In no event shall the adjusted minimum rent be less than the minimum rent in existence immediately preceding the adjustment.

Percentage Rates

Percentage leases shall provide for adjustment of percentages rates every ten (10) years to current fair market rates. For the purposes of determining fair market rent percentage rates, the City shall adopt and publish a schedule of benchmark percentage rates that will be updated to current market rates on a periodic basis by appraisal. The appraisal

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

will be guided by prevailing market percentage rates for similar operations primarily within the Southern California area.

G. Flat Rate Leases**Market Rate Adjustments**

Flat rate leases shall provide for upward adjustment of rent every ten (10) years to current fair market rent. In no event shall the adjusted rent be lower than the rent in existence immediately preceding the adjustment.

Consumer Price Index Adjustments

Flat rate leases shall provide for upward adjustment of rent in the interval term between market rate adjustments by changes in the consumer price index. In no event shall the adjusted rent be lower than the rent in existence immediately preceding the adjustment. The index used for consumer price index adjustments will be the All Urban Consumers index for Los Angeles - Riverside - Orange County, California with a base year of 1982-84. If the U.S. Department of Labor indices are no longer published, another substitute index generally recognized as authoritative will be used. Flat rate leases may include pre-determined periodic increases to rent instead of consumer price index adjustments. These periodic increases would occur at least every five (5) years.

H. Rent Arbitration

Leases shall provide for binding arbitration when the City and lessee cannot agree on the new rent for a rental period under review. The City and lessee shall each select a professional independent real estate appraiser who in turn will select a third independent real estate appraiser to determine the fair market rent. If the two selected appraisers fail to mutually select a third appraiser, then the third appraiser will be appointed by the presiding judge of the Superior Court of the State of California, County of San Diego. If the Superior Court judge declines to make the appointment, then the third appraiser shall be determined in accordance with the rules of the American Arbitration Association. The City and lessee shall pay the cost of its own selected appraiser and equally share the cost of the third appraiser.

I. Appraisal Assumptions

City leases shall include a definition of the fair market value to be used to adjust rent an identification of the premise for that value. In establishing the fair market value of leased property, any appraisal shall consider the property as a fee simple absolute estate and as vacant and available for lease or sale for the authorized purposes of the lease at the commencement of the rental period under review. Rates established for purposes of periodic percentage rental adjustments shall not consider any abatement as may be appropriate in a "new" development of vacant land. It shall also be assumed that all required regulatory approvals to permit the use authorized in the lease have been obtained.

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY**J. Lease Term****Short-Term Lease**

In accordance with San Diego Municipal Code §22.0901, the Mayor, at all times, shall have power, without advertising, notice, or competitive bidding, and upon such terms as the Mayor may deem proper, to lease any City property for a term of three (3) years or less (short-term lease). The City Council will be notified of a short-term lease not later than fifteen (15) days following its execution. A short-term lease may not be renewed without approval of the City Council. The Mayor may also execute rental agreements covering month-to-month tenant occupancy of City-owned residential housing.

Long-Term Lease

A lease in excess of three (3) years requires a resolution passed by a majority vote of all members of the City Council.

The length of lease term shall be based on the level of capital improvements to be made by the lessee and the economic life expectancy of the development. These factors can be determined utilizing cost estimating and economic life expectancy resources such as tables provided by Marshall Valuation Service. The City may consider other relevant information in determining if a longer lease term is warranted, such as if the proposed leasehold development is expected to generate above average returns to the City or significantly improve the quality of the property.

K. Lease Amendments

Amendments to long-term leases require City Council approval. The City's agreement to an amendment may be contingent upon updating sections of the lease to incorporate current City standard lease provisions and an adjustment to fair market rent.

L. Subleases

A lessee may sublease all or part of the leased property to a qualified sub-lessee subject to approval by the City. No sublease shall be approved which would be detrimental to the City's rights under the master lease or for a use that is not consistent with uses allowed by the master lease. The Mayor may authorize subleases which meet these conditions and which do not require amendment of the master lease. Unless special circumstances exist, leases shall provide for the City to receive a minimum of fifty percent (50%) of the incremental gross rental revenues due to the lessee from subleases.

M. Leasehold Financing

The City will not subordinate its fee interest to encumbrances placed against any leasehold by a lessee. The Mayor may approve appropriate financial encumbrances of the leasehold interest, which provide that all loan proceeds are used for authorized improvement of the property until the leasehold is fully developed in accordance with the lease. City staff shall

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

take appropriate steps to review the proposed financing and insure that loan proceeds go into the leasehold. Maximum loan proceeds shall not be in excess of seventy-five percent (75%) loan-to-value, where “value” refers to the leasehold improvements, as determined by a lender’s appraisal which has been reviewed and approved by City staff. The loan term shall not exceed the term of the lease.

Loans or refinancing in the form of encumbrances against the lease for the purpose of reducing equity or financing the sale of leasehold interest will not be allowed until the property is fully developed for uses authorized in the lease. After the property is developed, such financing may be permitted so long as there is also substantial benefit to be gained by the City. This may take the form of either a percentage share of the loan proceeds or an upward adjustment to the rent. Either of which shall be based on commercially reasonable comparables found in the market.

N. Leasehold Improvements

Leasehold improvements installed by lessees shall be removed at the lease termination without cost to the City, or will revert to the City, at the City’s option. All leasehold improvements and alterations require prior written approval of the Mayor.

O. Maintenance and Utilities Responsibility

City leases shall require the lessee to maintain all improvements on the property at its own expense and be responsible for the cost of all utilities. Leases for multi-tenanted space shall include specific requirements delineating appropriate responsibilities.

P. Lease Audits

All percentage leases shall be audited by the ~~City Auditor and Comptroller~~ City Treasurer in the first year of operation to establish proper reporting procedures and at least once every three (3) years thereafter. More frequent audits may be made if appropriate. The City shall reserve the right to audit all other leases and agreements subject to this Council Policy, if determined to be warranted by the ~~City Auditor and Comptroller~~ City Treasurer.

Q. Leasehold Assignments

Requests for assignment of leasehold interest shall be evaluated on the same basis as the criteria used in evaluating a leasehold proposal. The Mayor may authorize assignments which do not require amendment of the master lease. Consent may be contingent on the payment of additional consideration to the City, either as a percentage share of the purchase price of the leasehold interest or an upward adjustment to the rent. Either of which shall be based on commercially reasonable comparables found in the market. If new financing is involved in the sale, the requirements of ‘Leasehold Financing’ shall apply.

R. Lease Extensions & Renewals

Requests from existing lessees for lease extensions or renewals may be considered if such proposals promote capital investment and redevelopment of City property. Whenever an existing lessee is seeking renewal of an expiring long-term lease that is not contemplated in

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

a previously approved Portfolio Plan, the Mayor will bring the issue before the applicable City Council Committee with an appropriate recommendation. In addition to the criteria used to assess new lease proposals, City staff also will review the lessee's history with respect to: maintenance of the property; compliance with existing lease terms; prompt rent payments; and a rental return consistent with maximizing the property's full potential.

The lessee must propose capital investment that: will increase the value or the useful life of the leasehold improvements by an amount more than can be reasonably amortized over the remaining lease term; is not recurring in nature; and is at least ten percent (10%) or more of the value of the existing improvements. It specifically should exclude expenditures to correct deferred maintenance and expenditures for repairs to keep the existing improvements in good condition. The length of any extended lease term shall be calculated by the same method used for calculating the length of new leases.

S. City's Interest in Leasehold Improvements

City lease agreements provide the City the right to assume ownership of the leasehold improvements at the end of the lease. The value of the City's interest in the leasehold improvements can be appraised using widely accepted appraisal methods. In the event the City grants a lessee a lease extension, the City shall be compensated by an amount equal to the change in present value attributable to the deferral of its interest in the leasehold improvements. This amount either can be paid as an upfront payment at the beginning of the extended term or amortized over time with appropriate interest applied. The City shall offset from the value of its interest in the leasehold improvements any increased economic benefit derived from an extended lease. The City shall not receive any compensation for its interest in the leasehold improvements on leases extended prior to the last twenty percent (20%) of the existing term.

T. Security Deposits

The standard security deposit for a new lease agreement shall be equivalent to three (3) month's rent. The security deposit may take the form of cash, an instrument of credit or a faithful performance bond. For a lessee making a substantial investment in improvements, the security deposit will be refunded upon completion of the improvements.

U. Transaction Processing Fees

The City may charge a transaction processing fee in accordance with the schedule of fees adopted pursuant to Administrative Regulation 95.25. The fee may be waived for transactions that provide benefit to the City.

CROSS REFERENCE:

Council Policy 700-04 - Balboa Park Uses and Occupancy

Council Policy 700-08 - Mission Bay Park Policies

Council Policy 700-12 - Disposition of City Property to Non-Profit Organizations

CITY OF SAN DIEGO, CALIFORNIA

COUNCIL POLICY

Council Policy 700-15 - Airport Policy

Council Policy 600-43 - Telecommunication Antennae Policy

HISTORY:

“Assignment and/or Subletting of City Leases”

Adopted by Resolution R-169946 03/15/1962

Retitled to “Disposition of Surplus City-Owned Real Property” and

Amended by Resolution R-208091 06/05/1973

Amended by Resolution R-212957 04/04/1975

Amended by Resolution R-217309 12/21/1976

Amended by Resolution R-218125 04/12/1977

Amended by Resolution R-219507 10/19/1977

Amended by Resolution R-220842 05/09/1978

Amended by Resolution R-224022 07/16/1979

Amended by Resolution R-250319 10/01/1979

Amended by Resolution R-251154 02/11/1980

Amended by Resolution R-251943 06/02/1980

Amended by Resolution R-252266 07/14/1980

Amended by Resolution R-252313 07/21/1980

Amended by Resolution R-252966 10/27/1980

Amended by Resolution R-255014 09/15/1981

Amended by Resolution R-258160 03/28/1983

Amended by Resolution R-258896 07/18/1983

Amended by Resolution R-300187 03/01/2005

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: May 7, 2010**IBA Report Number:** 10-39**Audit Committee Docket Date:** May 10, 2009**Item Number:** # 6

Analysis Related to a Proposal to Transfer the City Treasurer's Revenue Audit Program to the Office of the City Auditor

OVERVIEW

In his FY 2010 Budget Recommendations Memorandum dated April 30, 2009, Councilmember Young requested that the Mayor and City Auditor review and take action on transferring the functions of the Treasurer's Revenue Audit Program (RAP) to the Office of the City Auditor. On March 17, 2010, the Budget and Finance Committee adopted a motion requesting the IBA analyze considerations surrounding the RAP transfer proposal. The Committee requested the IBA's analysis be presented to the Audit Committee. In reviewing the proposed FY 2011 budget for the City Auditor on April 12, 2010, the Audit Committee also requested analysis of the proposal to transfer the City Treasurer's RAP to the Office of the City Auditor.

In response to this direction, the IBA has independently met with the City Treasurer and the City Auditor to discuss their perspectives regarding the revenue audit function. Additionally, we surveyed other major cities in California and in the nation. This report provides an overview of the RAP, presents City Treasurer and City Auditor perspectives related to the proposed transfer, discusses the organizational location of the revenue compliance audit function in other cities, and offer final comments for Audit Committee consideration.

FISCAL/POLICY DISCUSSION

Revenue Audit Program

Until 2006, the RAP was a work unit within the Office of the City Auditor and Comptroller. In June of 2006, the previous City Auditor and management agreed to move the RAP from the

Office of the City Auditor and Comptroller to the Office of the City Treasurer. The previous City Auditor and Comptroller believed 1) synergies could be achieved by consolidating these revenue audits with the City Treasurer collections function, 2) revenue compliance audits better matched with the revenue collection function and 3) it would be difficult for the Office of the City Auditor and Comptroller to independently audit the revenue audit group while simultaneously managing the function particularly if revenue and performance auditors were rotated between audit types. The decision to transfer the RAP to the City Treasurer took place before the City acted to separate the City Comptroller and City Auditor functions to create greater audit independence.

As noted above, the RAP currently operates within the Office of the City Treasurer. It is comprised of 6.00 FTEs including 1.00 Principal Accountant (who manages the group and performs audits), 3.00 Accountant IIIs and 2.00 Accountant IIs. The Principal Accountant reports to a Financial Operations Manager who in turn reports to a Treasury Operations Manager. The Treasury Operations Manager reports directly to the City Treasurer. The proposed FY 2011 budget (total salaries and fringe benefits) for 6.00 RAP FTEs is approximately \$630,000.

Between FY 2004 and FY 2008, the RAP was staffed with between 4.00 and 8.00 FTEs although some of these positions were periodically vacant or dedicated to managing the group. As noted in a memorandum from the City Treasurer to the Chief Financial Officer dated May 15, 2009 (Attachment 1), RAP audits have resulted in annual revenue recoveries between \$1.2 million and \$2.5 million between FY 2004 and FY 2008. Due in part to 2.00 positions being vacant throughout FY 2009, revenue recoveries declined to \$789,000 in the last fiscal year. The majority of RAP's annual revenue recovery results from revenue compliance audits of hotels, with a lesser amount attributable to audits of lease or franchise agreements.

Revenue compliance audits focus on whether or not revenues owed to the City have been calculated and paid correctly. According to the City Treasurer, "a typical revenue audit involves reviewing financial statements and general ledgers, testing detailed accounting records for accuracy and reliability; confirming compliance with governing sections of the Municipal Code and lease or franchise agreements; and making recommendations to administering departments based on audit findings." RAP staff currently performs the following types of revenue compliance audits:

- Transient Occupancy Tax (approximately 311 hotels in City subject to audit)
- Percentage Leases with businesses on City owned property (approximately 101 leases)
- Franchise Agreements - SDG&E, waste haulers (3), cable companies (2), other (2)
- Business Tax Payments – under certain circumstances
- Special requests by City departments for unique agreements with City revenue elements

The managing Principal Accountant for the RAP indicates that approximately 60% of staff time is spent performing TOT revenue audits. A very small percentage of staff time (< 5%) is spent on audit appeal hearings. While the program places a higher priority on high revenue hotels, it also endeavors to audit all hotels on a two to three year cycle. Hotels are not required to maintain records after three years; however, they can still be audited and found to be deficient in their payments to the City after three years.

City Treasurer Comments Regarding the Proposed Transfer of the RAP

In discussing the contemplated transfer of the RAP with the City Treasurer and the Principal Accountant, the following perspectives were shared:

1. If the City Auditor were to perform revenue compliance audits, he would not be able to independently audit this revenue collection process which is a management responsibility. As the City is currently organized, the City Auditor can independently audit the RAP or any other City Treasurer revenue billing/collection process for effectiveness or efficiency.
2. City Charter Section 39.2 requires the City Auditor to follow Government Auditing Standards which require all audits to adhere to very specific audit protocols and procedures (stipulated in what is known as the Yellow Book). These procedures were developed for, and are more pertinent to, performance audits which are the focus of the City Auditor. They are not as applicable to revenue compliance audits. Organizations like the Internal Revenue Service, Franchise Tax Board or the State Board of Equalization conduct revenue compliance audits and are not subject to Yellow Book standards. The concern is that added, unnecessary audit procedures would be more cumbersome and result in a less efficient RAP.
3. All of the current RAP staff possess degrees in accounting; half of the staff either are or are about to become Certified Public Accountants. Additionally, RAP staff possesses significant experience performing revenue compliance audits. Accounting expertise and experience is needed to effectively perform revenue compliance audits. While these skill sets could be transferred to the Office of the City Auditor, they should not necessarily be considered interchangeable with City Auditor staff whose training and experience tends to be oriented toward conducting performance audits.

City Auditor Comments Regarding the Proposed Transfer of the RAP

In discussing the contemplated transfer of the RAP with the City Auditor and the Managing Performance Auditor, the following perspectives were shared:

1. The City Treasurer bills and collects revenue for the City. As they report to management, there may be a conflict for the RAP to audit a process they are charged with administering. The City Auditor believes there is greater independence and transparency when an office that is independent of management conducts the revenue compliance audits. For example, the City Auditor publicly presents an annual audit work plan that does not allow for discretionary audit decisions which the City Auditor notes may not be the case for revenue audits under management.
2. The Office of the City Auditor conducts all audits in accordance with Government Accounting Standards (Yellow Book). The Yellow Book requires audit documentation, standards and audit protocols that have been designed to protect the integrity of the resulting audits. These standards would enhance the process and quality of revenue compliance audits. The application of Yellow Book audit standards should not result in a less efficient RAP.

3. Transferring the RAP into the Office of the City Auditor will develop synergies and efficiencies. It is envisioned that the program would report directly to the City Auditor and his senior performance audit managers who have considerable audit experience. The City Auditor's staff is experienced in conducting audits in accordance with Government Accounting Standards. Additionally, City Auditor staff receives specialized training and discusses innovative approaches to auditing with their peers in the audit profession. This information would be shared with RAP staff in a more synergistic environment entirely dedicated to auditing.

Revenue Compliance Audit Responsibilities in Other Cities

In researching where responsibility for revenue compliance audits is located in other cities we found that most cities have finance/revenue related departments performing this function. These same cities also have independent audit offices that primarily perform performance audits but may perform other types of revenue audits. Our research indicates that revenue compliance field audits are more typically performed, or overseen, by finance/revenue related departments. The following cities were contacted:

<u>City</u>	Revenue Compliance Audits <u>Performed By</u> >>>>>>	<u>Reports To</u>	Independent Audits <u>Performed By</u>
Los Angeles	Office of Finance	Management	Elected City Controller
San Jose	Finance Department	City Manager	Appointed City Auditor
San Francisco	Elected Treasurer	Public	Appointed Controller
Fresno	Controllor	City Manager	Budget Director
Long Beach	Elected City Auditor	Public	Elected City Auditor
Oakland	Finance & Mgmt Agency	Management	Elected City Auditor
Chicago	Department of Revenue	Management	Council Finance Cmte.
Philadelphia	Revenue Department	Management	Elected City Controller
San Antonio	Finance Department	City Manager	Appointed City Auditor
Phoenix	Finance Department	City Manager	Appointed City Auditor
Dallas	Financial Services Dept	City Manager	Appointed City Auditor
Detroit	Finance Department	Management	Appointed City Auditor

With the exception of Long Beach whose elected City Auditor administers a contract for the provision of revenue compliance audits, we did not identify a city whose revenue compliance audits were entirely performed or overseen by the independent City Auditor. The Principal Accountant for RAP provided the IBA with recent data he gathered indicating that the ten largest cities in the nation (based on population) have finance/revenue related departments performing or overseeing revenue compliance audits; however, we were only able to confirm this for eight of the top ten cities prior to the release of this report.

Additional IBA Comments for the Audit Committee

After discussing the contemplated transfer with involved City departments and staff in other cities, the IBA offers the following comments for Audit Committee consideration:

1. Based on comments received from the City Treasurer about her City Charter specified duties, the IBA preliminarily discussed the contemplated transfer of RAP with the Office of the City Attorney. The City Attorney's Office has some concern that such a transfer may be subject to certain legal implications that the Audit Committee should consider. We recommend that the Audit Committee request an opinion from the Office of the City Attorney with regard to any legal implications related to a proposed transfer. We would also note that the proposed transfer may also be subject to a meet and confer process with MEA.
2. While there are similarities in the nature of all audit work, there are a few notable differences between the City's revenue compliance and performance auditors. These differences include:
 - Revenue compliance audits are external to the organization while performance audits are more typically internal organizational audits.
 - The scope/audit approach and nature of the duties involved.
 - Auditor education/training/experience as it best relates to each audit type.
 - Current differences in employee classification: RAP employees are classified/represented whereas City Auditor employees are unclassified/unrepresented.
 - Compensation: performance auditors currently receive significantly higher compensation than revenue compliance auditors, including salary and benefits.

While these differences do not preclude consolidation of the two work units, they could impact staff integration and interchangeability as it relates to the possibility of creating efficiencies by consolidating audit operations.

3. Based on information provided by the City Treasurer, approximately 120 hotel audits since 2005 had audit periods of more than three years. As hotels are not required to maintain audit records after three years, the City's audit (and potential revenue recovery) position is weakened (not eliminated) after three years. Audit cycles exceeding three years are typically attributable to insufficient budgeted staff, staff vacancies and/or competing revenue audit needs.
4. Using revenue recovery data provided by the City Treasurer for FY 2004 through FY 2008 (based on the number of RAP staff actually performing audits), we roughly estimate that RAP's revenue recovery to auditor expense ratio ranged from 2.4:1 to 6.2:1 for each dollar spent over the five year period. The RAP brings in significantly more revenue than it costs; however, this does not mean that this revenue recovery ratio could not be further enhanced. Understanding that the amount of revenue recovered may vary from year to year based on factors not tied to the audit process, the IBA recommends that a historical revenue recovery ratio be validated and used as one go-forward benchmark for evaluating work unit performance wherever the function is located.

5. The City Auditor and the City Treasurer each make reasonable audit independence arguments. Both assert the other cannot independently audit a work process they are responsible for; however, the IBA believes either argument can be mitigated. If the City Treasurer retains revenue compliance audits, the City Auditor can audit their operation at any time and make process recommendations with respect to the timing, selection and execution of audits. If the City Auditor were to assume revenue compliance audits, the Audit Committee could request that an outside audit firm be retained to periodically perform an independent audit of this function.

CONCLUSION

In response to direction from the Budget & Finance and Audit Committees, the IBA has provided information related to a contemplated transfer of the City Treasurer's RAP to the Office of the City Auditor. We have described the nature of the RAP function and its organizational placement at the City. Additionally, we have surveyed other major cities to report which departments typically perform the revenue compliance audit function within each organization. Finally, we have provided additional comments for Audit Committee consideration.

While there are notable differences in the nature of the work performed by revenue compliance and performance auditors, we believe the work units could be consolidated if the City Council determines that greater operating and revenue efficiencies can be achieved. We have suggested ways to ensure that the revenue compliance audit function can be objectively performed and independently audited for efficiency and effectiveness irrespective of where responsibility for the function is assigned within the organization.

As noted in this report, the IBA recommends the Audit Committee request an opinion from the Office of the City Attorney regarding any legal implications related to a proposed transfer of the RAP.

The IBA believes that a determination as to where the revenue compliance audit function is located within the organization should be based solely on operating efficiency and effectiveness. The City's current organizational structure for this function is similar to that of almost all major cities. We would suggest a recommendation to transfer the RAP only be made if the Audit Committee is convinced that the City Auditor can develop and realize significant operating efficiencies that could not otherwise be achieved by the Office of the City Treasurer.

[Signed]

Jeff Kawar
Fiscal & Policy Analyst

[Signed]

APPROVED: Andrea Tevlin
Independent Budget Analyst

Attachment



THE CITY OF SAN DIEGO

M E M O R A N D U M

DATE: May 15, 2009

TO: Mary Lewis, Chief Financial Officer

FROM: Gail R. Granewich, City Treasurer 

SUBJECT: Revenue Audit Program – Quarterly Report
and Response to FY 2010 Budget Discussions

Quarter Ending March 31, 2009 – Audits Completed

During the third quarter of Fiscal Year 2009, the Office of the City Treasurer's Revenue Audit Program completed 26 audits, totaling \$279,606 in audit deficiencies. The 26 audits included 20 tax-related audits and 6 lease audits, including:

Transient Occupancy Tax/Business Tax Audits

- W San Diego
- 500 West Hotel
- Doubletree Del Mar
- Ramada San Diego North
- Two (2) non-compliant vacation rental properties

Lease Audits

- Ace Parking operations at Qualcomm Stadium
- Canyonside Stables, LLC
- Crystal Pier Motel, Inc.
- Seaforth Sportfishing Corp.
- Wave House Belmont Park
- Rancho Santa Fe Polo Club

Quarter Ending March 31, 2009 – Recoveries

During the third quarter of Fiscal Year 2009, the City received \$200,006 in recoveries on performed audits, including \$57,636 received by the Office of the City Treasurer's Delinquent Accounts Collection Division.

Current Quarter (Ending June 30, 2009)

Major TOT and lease audits expected to be completed during the current quarter include:

- Residence Inn Mission Valley
- Holiday Inn Mission Valley
- Sheraton Suites San Diego
- Sheraton Suites Shelter Island
- San Diego Visitor Information Center
- SDSU Football use of Qualcomm Stadium
- KenCal Ownership (Hyatt Islandia)
- NextG Networks (Use Permit)

2009 Fiscal Year-to-Date Totals

Revenue audits completed and recoveries through the third quarter ending March 31, 2009:

Table A

Type	Audits Completed	Audit Hours	Audit Deficiencies	Recoveries
TOT	71	2,652	\$537,142	\$382,035
Lease/Franchise	15	1,707	\$199,472	\$168,937
Requested (BT)	5	14	\$4,940	\$3,160
Total	91	4,373	\$741,554	\$554,132

As a reminder, of the 65 revenue audits completed during the first and second quarters of this fiscal year, some of the more significant audits included:

Transient Occupancy Tax/Business Tax Audits

- Western Inn Old Town
- Bahia Hotel
- Studio 819
- Staybridge Suites Sorrento Mesa
- Holiday Inn Express
- US Grant Hotel
- Hotel Occidental
- Staybridge Suites Carmel Mountain
- Embassy Suites La Jolla
- Holiday Inn on the Bay

Lease Audits

- San Diego Chargers Football Company
- Wesco Sales Corp.
- Paradise Café II
- San Diego Bowl Game Association
- The Lodge at Torrey Pines
- Catamaran Hotel (and two associated operations)

Staffing Updates

The Revenue Audit Program continued to operate with two open positions during the third quarter. Requests to fill these positions were approved and one vacancy was filled in late April, the other is expected to be filled by early June.

Response to Councilmember Young's Fiscal Year 2010 Budget Recommendation

In a memorandum dated April 30, 2009, Councilmember Anthony Young requested "the Mayor and City Auditor to review and take action on transferring the functions of the Revenue Audit and Appeals division of the City Treasurer's office into the Office of the City Auditor." He further indicated that savings would result from this consolidation and that the revenue audit function should be under the Independent Auditor.

This section of the report provides background on the Revenue Audit Program and results from the prior five (5) years.

Background

The Office of the City Treasurer's Revenue Audit Program has been performing audits of revenue-generating businesses within the City limits since the mid-1960s. Originally, the program was part of the Audit Division within the department of the Auditor and Comptroller. In June of 2006, and consistent with City Charter §45, the Revenue Audit Program was transferred under the oversight of the City Treasurer. City Charter §45 states in part:

The Treasurer shall issue notices for and collect...miscellaneous taxes, fees, assessments, licenses and privilege charges as may from time to time be assigned to him or her. He or she shall maintain a continuous inspection of the records and accounts of such taxes, licenses and privilege charges in order to effectuate their collection.

As indicated in **Table B** below, many other large jurisdictions place the revenue audit function within its main revenue receiving department.

Table B

Municipality	Location of Revenue/Tax Audit Function	Municipality	Location of Revenue/Tax Audit Function
Los Angeles	Office of Finance	Phoenix	Finance Department
Chicago	Revenue Department	San Antonio	Finance Department
Houston	Finance Department	San Jose	Finance Department
Philadelphia	Revenue Department	San Francisco	Treasurer and Tax Collector

The transfer of the Revenue Audit Program to the Office of the City Treasurer also cleared the way for the Office of the City Auditor to be established as a separate, independent department focused on the operations of the City as set forth in City Charter §39.2. The operations, focus, procedures and audit techniques of the revenue audit function differ from the City Auditor's role and responsibility. Revenue auditors focus on whether or not revenues paid to the City have been made correctly, whereas internal auditors focus on overall efficiencies and controls of an organization.

The move to the Office of the City Treasurer has in fact streamlined revenue audits. The Revenue Audit Program now exists within the department which, as required by City Charter, administers the City's tax codes and receives lease and franchise fee payments on behalf of administering departments.

As referred to in City Charter §45, the City Treasurer's Revenue Audit Program exists to "...maintain a continuous inspection of the records and accounts..." of the taxes, rents and fees paid to the City. These include the Transient Occupancy Tax paid by all hotels, motels and property management companies within the City; rent payments made by all of the City's percentage rent lessees; and franchise fees paid by all waste haulers, cable companies and utilities operating within the City limits. Audits are also done on certain business tax payments on an as-needed basis only, due to the high rate of compliance in the department's FTB Compliance Program.

A typical revenue audit involves reviewing financial statements and general ledgers; testing detailed accounting records for accuracy and reliability; confirming compliance with governing sections of the Municipal Code and lease or franchise agreements; and making recommendations to administering departments based on audit findings.

Over the past five years, through detailed and thorough revenue auditing and analysis, the Revenue Audit Program has brought in the following recoveries:

Table C

Year	No. of Audits	Audit Hours	Recoveries	FTEs
2008	98	4,706	\$1,367,209	5
2007	136	5,648	\$2,474,149	5
2006	118	6,099	\$1,704,618	5
2005	165	8,603	\$1,530,616	6
2004	174	8,601	\$1,194,404	6

The main types of revenues audited by this program and included in the summary results in **Table C** are:

Transient Occupancy Tax

The City imposes a Transient Occupancy Tax of 10.5% on hotel guests for the privilege of occupying a room in a hotel, motel, RV park, or vacation rental within the City limits. Operators of these establishments have the responsibility to collect the tax and remit it to the City. Revenue audits are performed on the payments made by these operators. These audits also include a review of the recently adopted Tourism Marketing District fee of 2%, assessed on revenues of hotels with 70 or more units.

Authority to Audit: SDMC §35.0121

Number in Audit Population: 308

Frequency of Audits: Every Two to Three Years

Table D

Fiscal Year	No. of Audits	Audit Hours	Total Recoveries
2008	86	3,378	\$846,661
2007	95	3,787	\$2,095,083
2006	73	3,154	\$638,127
2005	106	3,855	\$435,839
2004	115	5,211	\$621,097

Percentage Lease Agreements

The City has a number of lease agreements with businesses operating on City owned land. The bulk of these lease agreements exist at Mission Bay and the San Pasqual Valley. The lease agreements are administered by the City's Real Estate Assets Department. Additionally, the City has a few tenant agreements with businesses operating within Qualcomm Stadium. Revenue audits are performed on each of these lessees and permittees as well.

Authority to Audit: Within Individual Lease Agreements
Number in Audit Population: 87
Frequency of Audits: Every Two to Four Years

Table E

Fiscal Year	No. of Audits	Audit Hours	Total Recoveries
2008	11	1,133	\$350,150
2007	25	1,471	\$237,783
2006	29	2,411	\$257,750
2005	44	4,448	\$991,314
2004	40	2,954	\$516,192

Franchise Agreements

Franchise Fee payments are made to the City by utility companies, waste haulers and cable companies operating within the City limits. Revenue audits are performed on each of these franchisees.

Authority to Audit: Within Individual Franchise Agreements
Number in Audit Population: 18
Frequency of Audits: Every Three to Four Years

Table F

Fiscal Year	No. of Audits	Audit Hours	Total Recoveries
2008	1	195	\$170,398
2007	2	323	\$112,116
2006	3	481	\$760,241
2005	3	242	\$86,044
2004	4	314	\$35,432

Revenue auditing has a specialized focus, requiring specific training and accounting expertise. Revenue Audit Manager, Douglas Enger, is a Certified Public Accountant and has worked exclusively conducting revenue audits for the City of San Diego for 12 years.

Mary Lewis
May 15, 2009
Page 7 of 7

ATTACHMENT 2

The total recoveries achieved by the Revenue Audit team over the past five years show that the Revenue Audit Program is providing an outstanding return to the City under the Office of the City Treasurer where the Charter required focus on revenue is paramount. I have a high performing, well qualified team. I do not believe that relocation of the revenue audit function under the City Auditor would result in additional efficiencies, cost savings or an increase in revenue.

cc: Elizabeth Correia, Financial Operations Manager
Douglas Enger, Revenue Audit Manager

Office of
The City Attorney
City of San Diego

MEMORANDUM
MS 59

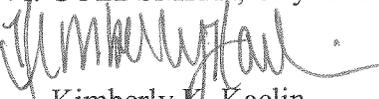
(619) 236-6220

DATE: September 15, 2011
TO: Audit Committee
FROM: City Attorney
SUBJECT: Memoranda of Law regarding City Auditor Authority

We received a copy of the City Auditor's e-mail to the Audit Committee dated September 12, 2011, regarding his request for advice from our Office on his authority to audit revenues, expenses, and other activities of various entities. As you may recall, our Office reviewed the Auditor's authority to conduct certain revenue audits in our Memorandum of Law (MOL) dated June 10, 2010 (City Att'y MOL-2010-12 (June 10, 2010)), a copy of which is attached as Attachment 1. A few months ago, the Auditor asked us to revisit our 2010 analysis and conclusions in that MOL. In response, we prepared a memorandum dated August 12, 2011, which concluded that our 2010 opinion remained the same. The Revenue Audit Division of the City Treasurer may not be transferred to the City Auditor. However, the memo further provided that the Auditor does have authority to audit the Revenue Audit Division of the Treasurer's Office.

The August 12, 2011, memorandum was not released after the Auditor advised us that he wanted our Office to answer a different set of questions. These questions were sent to us on September 1, 2011, and forwarded by the Auditor to the Audit Committee on September 12, 2011. We will be working with the Auditor to narrow the scope of such questions. To the extent that the Auditor's questions have not already been answered in the 2010 MOL or in the follow up memorandum dated August 12, 2011, we will provide additional legal analysis regarding the Auditor's authority to audit different entities. In the meantime, we are releasing our August 12, 2011, memorandum (City Att'y MS-2011-10 (Aug. 12, 2011)) as it provides additional legal analysis of some of these issues. A copy is attached hereto as Attachment 2.

JAN I. GOLDSMITH, City Attorney

By 
Kimberly K. Kaelin
Deputy City Attorney

KKK:jb
Attachments
cc: Eduardo Luna, City Auditor

MARY JO LANZAFAME
ASSISTANT CITY ATTORNEY

JOSEPHINE A. KIERNAN
DEPUTY CITY ATTORNEY

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO

Jan I. Goldsmith
CITY ATTORNEY

ATTACHMENT 3
1200 THIRD AVENUE, SUITE 1620
SAN DIEGO, CALIFORNIA 92101-4178
TELEPHONE (619) 236-6220
FAX (619) 236-7215

MEMORANDUM OF LAW

DATE: June 10, 2010

TO: City of San Diego Audit Committee

FROM: City Attorney

SUBJECT: Proposed Transfer of the Functions of the Revenue Audit Division of the Treasurer's Office to the City Auditor's Office.

INTRODUCTION

As part of the Fiscal Year 2011 budget considerations, Councilmember Anthony Young, as Chair of Council's Committee on Budget and Finance, suggested that the Mayor and City Auditor "review and take action on transferring the functions of the Revenue Audit and Appeals division of the City Treasurer's Office into the Office of the City Auditor" as a cost saving measure. Councilmember Young Memorandum at 1 (Apr. 30, 2009). The Audit Committee of the City of San Diego (Committee) considered this proposal at its May 10, 2010 meeting, reviewing a number of reports.¹

The proposed transfer of functions will affect the City Auditor's budget, which the Committee recommends to the City Council. The Committee requests the City Attorney provide it with a formal opinion assessing the legality of the proposed function transfer.

QUESTION PRESENTED

May the City Council transfer the functions of the Revenue Audit and Appeals Division (Revenue Audit Division) from the City Treasurer's Office to the City Auditor's Office?

¹ The Committee considered a Report from the Independent Budget Analyst (IBA) dated May, 7, 2010 (IBA Report No. 10-39); a Memorandum from the City Auditor dated May 7, 2010; a Memorandum from the City Treasurer dated May 10, 2010; and an outline from the City Attorney of potential legal issues involved in the transfer.

ATTACHMENT 1

SHORT ANSWER

No. The City Council may not legally transfer the functions of the Revenue Audit Division of the City Treasurer (Treasurer) to the City Auditor's Office. San Diego Charter section 45 places an express duty on the Treasurer to maintain a continuous inspection over special revenues she must collect from businesses, in order to effectuate collection of the revenue. The Treasurer meets this Charter duty through the Revenue Audit Division, which conducts periodic inspections of the records of businesses which remit the special revenues to the City, to ensure the revenues remitted are correct. The Treasurer is part of the City's financial management and reporting structure. The collection of revenue is a management function.

The independent City Auditor was established in 2008 by Charter section 39.2. The City Auditor is tasked with auditing City departments and offices to provide the public and City officials with objective, nonpartisan assessment of the stewardship, performance, or cost of the City's policies, programs, and operations. To ensure independence from management, the City Auditor reports to the Audit Committee. A transfer to the City Auditor of a management (collection-of-revenue) function, which the Auditor must audit, conflicts with the Charter and Government Auditing Standards' requirements for Auditor independence.

BACKGROUND

The City reformed its auditing and financial management systems in 2008 in the wake of a Securities and Exchange Commission (SEC) investigation of the City's debt financing disclosures occurring in the early 2000's. The 2008 reforms generally followed the remediation recommendations of the Kroll Report (Report),² issued in 2006 after an eighteen month review of the City's governance.³ The Report frankly assessed the City's failures "to adhere to principles of sound governance and financial reporting" leading to the investigation. Kroll Report at 1. The City lacked internal controls necessary to ensure accuracy in the City's accounting and financial reporting. Kroll Report at 240-42. The Report recommended reorganization of the financial reporting structure to ensure greater accountability.⁴

In January 2006, the trial Strong Mayor form of government placed the City's financial management system, including the City Auditor and Comptroller, directly under Mayoral control.⁵ This improved accountability in the reporting system. The City's accounting, financial reporting *and* internal auditing duties were still combined in the single office of Auditor and Comptroller. The Report found that retaining the internal audit function within the management

² "Report of the Audit Committee of the City of San Diego" (August 8, 2006).

³ The City Council retained Kroll Inc., a group led by Arthur Levitt, former Chairman of the SEC, to independently assess City governance and recommend solutions to the City Council to remediate problems leading to the SEC investigation.

⁴ The reorganization included creating a Chief Financial Officer (CFO), who reported to the Mayor, or CEO, of the City, and a City Treasurer reporting to the CFO. Kroll Report at 245-46.

⁵ Under the City Manager form of government, the City Auditor and Comptroller was the City's chief fiscal officer, appointed by the City Council. Former San Diego Charter § 39. In January 2006, former Charter section 265(b)(10) and (11) gave the Mayor sole authority to appoint and to dismiss the Auditor and Comptroller, subject to the officer's right to appeal to the City Council.

structure lacked “the requisite level of independence widely viewed as essential for a sound financial reporting system.” Kroll Report at 250; also 246, n. 1273. The Report expressly recommended the City create a “separate internal auditing function” distinct from the Mayor in a new officer called an Auditor General, who would report to an Audit Committee, and serve for a term of ten years. *Id.* at 250-51. This would leave the City Departments responsible for financial reporting and accounting, such as a CFO, Comptroller, and Treasurer, in management’s organizational structure, and the City’s internal auditing and independent oversight functions in a separate one. *Id.* at 245-46.

A Charter Review Committee recommended Charter changes to the City Council in 2007, to implement the financial reforms.⁶ At the June 3, 2008 Municipal Primary Election, voters approved Proposition C, amending the Charter to comprehensively change the City’s financial reporting and accounting structure. The Charter changes: 1) supplanted the previous title of Auditor and Comptroller with a new title of CFO; 2) created a CFO appointed by the Mayor and confirmed by City Council; and 3) formally transferred all “[t]he authority, power and responsibilities conferred upon the Auditor and Comptroller by this Charter . . . to . . . the Chief Financial Officer.” San Diego Charter § 39. The measure placed the Treasurer under CFO supervision, removing the requirement the Treasurer’s appointment be confirmed by the City Council. San Diego Charter §§ 39, 45. It created an Audit Committee, independent of management, to supervise the new Charter office of City Auditor, created to assume the City’s internal audit functions. San Diego Charter §§ 39.1, 39.2 and 111.⁷

ANALYSIS

I. THE CHARTER DUTIES OF THE CITY TREASURER AND CITY AUDITOR.

San Diego is a charter city. As such, the City charter creates and forms our municipal government, “distribut[ing] the powers and duties of the various departments, boards and officers, and provid[ing] the manner in which the . . . powers shall be exercised.” 2A McQuillin Mun. Corp. § 9:3 (3rd ed. 2010). This means that when a charter creates a public office or body, the charter is the source of the body’s or officer’s authority and responsibilities. For example, the San Diego Charter creates and establishes the City Council, the Treasurer, the City Auditor, the Audit Committee, the Mayor, and the CFO among other Charter officers or bodies. Each body or officer has designated responsibilities and authority given to them by the Charter. However, unless the Charter expressly permits it, one Charter officer or body may not limit or impede the performance of another. *See* City Att’y MOL-2006-2 (Jan. 23, 2006) [Mayor may not interfere with Auditor and Comptroller Charter duties.]

⁶ The Mayor’s Charter Review Committee provided most of the language for the Charter amendments in Proposition C. *See* 2007 San Diego Charter Review Committee, Final Report (October 4, 2007). The City Council incorporated its modifications during January and February 2008. *See* City Att’y Reports RC-2008-1 at 5-9 (Jan. 14, 2008), and RC-2008-3 at 4-6 (Jan. 29, 2008).

⁷ Proposition C also created the IBA as a new Charter officer, giving the City Auditor and IBA full control over the hiring and dismissal of their assistants and deputies. San Diego Charter §§ 39.3 and 117(a)(11).

Charter provisions are construed in the same manner by courts as are constitutional provisions. *Woo v. Superior Court*, 83 Cal. App. 4th 967, 975 (2000). The principal determination is what voters intended in approving the charter provisions. Courts look first to the actual words of the provisions, giving “the usual, ordinary, and commonsense meaning to them.” *Howard Jarvis Taxpayers Ass’n v. County of Orange*, 110 Cal. App. 4th 1375, 1381 (2003). If the language is clear and unambiguous, the courts will presume the voters intended the meaning apparent on the face of the measure and end their inquiry. *Woo*, 83 Cal. App. 4th at 975. If there is some ambiguity in the language, courts may look to extrinsic aids, such as the information and arguments contained in the official ballot pamphlet, to indicate the voters’ understanding of the measure and their intent in passing it. *Id.* at 976.

A. San Diego Charter Section 45 Requires the Treasurer to Continually Inspect Certain Revenues To Effectuate Collection.

The Treasurer is part of the financial management of the City under Mayoral control. The Treasurer performs management and administrative functions pursuant to the Charter, generally involved in collecting, holding, and disbursing City funds. The Treasurer must keep the usual “books and records as are necessary for the recording of all receipts and expenditures” connected with these general duties. San Diego Charter § 45.⁸

The Charter also contemplates the Treasurer will be assigned to collect other special types of revenues, such as “special assessments . . . , charges for permits for private use of public streets, and such other miscellaneous taxes, fees, assessments, licenses and privilege charges” San Diego Charter § 45. Once assigned to collect these revenues, the Charter places additional duties on the Treasurer to “maintain a *continuous inspection* of the records and accounts of such taxes, licenses and privilege charges *in order to effectuate their collection.*” *Id.* (emphasis added).

This particular and express duty to “maintain a continuous inspection” “to effectuate . . . collection” is undefined in the City Charter, and this precise language is rarely seen elsewhere.⁹ The Treasurer meets this duty using the Revenue Audit Division¹⁰ to periodically inspect the records of the tax-regulated businesses and those businesses remitting percentage-based franchise fees, and rents for City-leased lands. If deficiencies are found during these inspections, appropriate collection actions are initiated. “[F]inance/revenue related departments” of other California cities also perform these periodic inspections, which are often called revenue compliance audits. See IBA Report No. 10-39 at 4. The Treasurer’s process is also consistent

⁸ Since 2008, the Treasurer is directly responsible to the CFO, the City’s chief fiscal officer in the management structure. San Diego Charter §§ 39, 260(b) and 265(b). The CFO must report monthly to the Mayor/Manager and Council on the City’s “revenue and expenses” so as “to show the exact financial condition of the City,” its Departments and offices. San Diego Charter § 39. The CFO receives the City revenue information for these reports from those reporting to her, including the City Treasurer.

⁹ In a brief online search, we found the Tulsa, Oklahoma Municipal Code similarly directs its Director of Finance to “maintain a continuous inspection of all taxes, assessments, licenses, and fees and other revenues due the City in order to effectuate their collection.” Tulsa Mun. Code § 601.

¹⁰ The Division consists of five accountants employed in the City’s classified service and one manager in the unclassified service.

with periodic inspection processes of regulated businesses or their records at all levels of government to ensure compliance with applicable regulations.

In the tax or revenue context, these inspections are usually called tax examinations or tax audits.¹¹ The City's local business tax ordinances mirror this accepted process and give the Treasurer specific collection, inspection, and audit authority consistent with the Treasurer's Charter duties. For example, the Treasurer is required to collect the City's Transient Occupancy Tax (TOT) from City businesses. San Diego Municipal Code (SDMC) §§ 35.0101-35.0138.¹² The TOT is imposed on City visitors renting certain lodgings in San Diego, calculated as a percent of the rent charged by the operator business. Business operators must collect and remit the proper amount of TOT monthly to the City. The tax scheme permits the City to "inspect" and "audit" the business records to cross-check the payments they send to the City with the business records on which they are based. SDMC §§ 35.0116(c) and 35.0121. It gives the Treasurer sole access to these business entities to complete the inspections or audits. SDMC § 35.0121. If a deficiency is found after an audit, the business is invoiced by the Treasurer. SDMC § 35.0116(c). The businesses can either pay the deficiency or appeal the determination. SDMC §§ 35.0117, 35.0118.

The plain language of Charter section 45 is not ambiguous. When the Treasurer is assigned to collect fees, assessments, taxes, or other like matters from outside entities, the Charter requires the Treasurer to continuously inspect the records of those entities to ensure the City collects the proper amount. The Treasurer fulfills this specific charter duty by using the accountants in the Revenue Audit Division to periodically inspect the records of the businesses remitting these fees and taxes, to effectuate collection of the appropriate amounts. *See* Treasurer Memorandum to Chief Financial Officer at 4 (May 15, 2009).

Accordingly, the Treasurer has a legal duty under the Charter to continuously inspect the records of businesses from whom she is assigned to collect special revenues in order to effectuate that collection. She appropriately meets that legal duty by these periodic inspections (revenue compliance audits) of those records to ensure the correct amounts are remitted to the City. These periodic inspections are an integral part of the Treasurer's special revenue collection duties, expressly imposed upon her by the Charter. In addition, these inspections serve management and administrative functions under the Charter as reformed in 2008, providing management with accurate revenue information for required reporting purposes under the Charter.

¹¹ The Internal Revenue Service (IRS) indicates: "There is no statutory or common law definition of the term 'examination.' However, an examination, or audit, may be described as the systematic inspection of the books and records of a taxpayer for the purpose of making a determination of the correct tax liability." http://www.irs.gov/govt/foia/article/0,,id=159772_00.html. Similarly, Black's Law Dictionary indicates a tax audit is "[a]n examination of books, vouchers and records, or other transactions possessing tax consequences, of a taxpayer" *Black's Law Dictionary* at 131 (6th ed. 1990).

¹² The Treasurer is also required to collect business taxes, and has the same rights of access to those business records. *See* SDMC §§ 31.0301, 31.0128, and 31.0140.

B. Charter Section 39.2 Requires the City Auditor to Be the City's Independent Auditor.

Charter section 39.2 governs the responsibilities and duties of the City's Auditor. In combination with Charter section 39.1, the sections were intended to create a "separate internal auditing function" apart from management control. Kroll Report at 250. Internal audits in general are "performed by personnel of a company to assure that internal procedures, operations, and accounting practices are in proper order." *Black's Law Dictionary* at 131 (6th ed. 1990).

Charter section 39.1 requires the Audit Committee to be "an independent body," whose composition and appointment process "ensure[s] its independence." The Committee has "oversight responsibility regarding the City's auditing, internal controls and any other financial or business practices required of [it] by this Charter." San Diego Charter § 39.1.¹³ It is "responsible for directing and reviewing the work of the City Auditor and the City Auditor shall report directly to the Audit Committee." *Id.*

Charter section 39.2 requires the City Auditor to either "be a certified public accountant or certified internal auditor" and to follow "Government Auditing Standards" (GAGAS). GAGAS, as the name suggests, provides legislators, government officials, and the public with "an independent, objective, nonpartisan assessment of the stewardship, performance, or cost of government policies, programs, or operations . . ." GAGAS § 1.01. Independent auditors use GAGAS to assess whether "(1) government manages public resources and uses its authority properly and in compliance with laws and regulations; (2) government programs are achieving their objectives and desired outcomes; (3) government services are provided effectively, efficiently, economically, ethically, and equitably; and (4) government managers are held accountable for their use of public resources." GAGAS § 1.02.

Charter section 39.2 gives the Auditor access to City officials and records, requiring City officials and employees to cooperate and disclose pertinent information.¹⁴ It permits the Auditor to "investigate any material claim of financial fraud, waste or impropriety within any City Department" and authority to "summon any officer, agent or employee of the City, any claimant or other person, and examine him or her upon oath or affirmation" for that investigation. San Diego Charter § 39.2. It contemplates the City Auditor to have access to the records of some outside entities who voluntarily contract with the City, in order to verify compliance with contract terms. Those are particular City contracts with "consultants, vendors or agencies," and appear generally to involve the spending or use of City revenue, not the receipt of revenue owed the City. *Id.* Charter section 39.2 does not authorize the City Auditor independent access to the

¹³ We have previously interpreted the meaning of the Committee's oversight responsibility. See City Att'y Report RC-2009-14 (June 11, 2009).

¹⁴ Charter section 39.2 provides in pertinent part: "The City Auditor shall have access to, and authority to examine any and all records, documents, systems and files of the City and/or other property of any City department, office or agency, whether created by the Charter or otherwise. It is the duty of any officer, employee or agent of the City having control of such records to permit access to, and examination thereof, upon the request of the City Auditor or his or her authorized representative. It is also the duty of any such officer, employee or agent to fully cooperate with the City Auditor, and to make full disclosure of all pertinent information."

records of business entities subject to the City's regulatory or taxation scheme, nor access to the records of franchisees, or entities leasing City property who owe money to the City.¹⁵

That voters intended the City Auditor to assess City processes and certain businesses contracting with the City is also consistent with information presented to them. The ballot materials specifically stated that "[t]he Mayor's supervision of the Auditor and Comptroller's duty to audit fiscal departments under Mayoral control raised concerns about the independence of internal audits." Ballot Pamp., Municipal Prim. Elect. (June 3, 2008), City Att'y Impart. Anal. Prop. C. Voters also understood that Proposition C would "more clearly separate the City's internal auditing function from supervision of the Manager (Mayor) by creating the new office of the City Auditor, which would be supervised by a restructured Audit Committee [T]he Auditor would perform the City's internal audits and investigations" *Id.*

Accordingly, we conclude Charter section 39.2 requires the City Auditor to audit City Departments and processes and to do so independent of City management. The independence of the City Auditor's Office is assured by requiring the Auditor report, not to management, but to the independent Audit Committee. This independent City audit system meets necessary GAGAS independence standards because "the audit function is organizationally placed outside the reporting line of the entity under audit and the auditor is not responsible for entity operations." GAGAS § 3.13. It permits the City Auditor to fulfill an *essential* City role: to provide "objective, nonpartisan assessment of the stewardship, performance, or cost of [the City's] policies, programs, or operations." GAGAS § 1.01. This permits the public, City Council, and other City Officials to know how well or poorly the City manages public resources and provides public services, and holds accountable those City Officials who perform poorly.

II. THE CITY COUNCIL MAY NOT TRANSFER THE TREASURER'S REVENUE AUDIT FUNCTION TO THE CITY AUDITOR.

Charter section 39.2 permits the City Auditor to "perform such other duties as may be required by ordinance" It is also well-established that a legislative body, like the City Council, has wide discretion, especially in the exercise of its budgetary authority. *Scott v. Common Council*, 44 Cal. App. 4th 684, 693 (1996), citing *Hicks v. Orange County Board of Supervisors*, 69 Cal. App. 3d 228, 235 (1977). This might prompt the belief that if the City Council ordains something, it must occur. But a city council's authority to act in budgetary capacity or by ordinance is not unlimited. A city council's authority in a charter city is limited by the city charter. "[I]t is well settled that a charter city may not act in conflict with its charter Any act that is violative of or not in compliance with the charter is void." *Domar Electric, Inc. v. City of Los Angeles*, 9 Cal. 4th 161, 171 (1994) (citations omitted). Several cases limit a legislative body's authority when it takes actions affecting the functions and duties of charter or statutory officers.

In *Hubbard v. City of San Diego*, 55 Cal. App. 3d 380 (1976), the City Council attempted to create by ordinance a department of legislative analyst with certain specified duties, which the

¹⁵ Whether or not any particular City agreement, lease, or franchise permits the City Auditor independent access to a business' records must be determined on a case by case basis.

court found to be administrative in nature. *Some* of the duties and responsibilities given to the new department duplicated or overlapped those required by the Charter of the City Manager. However, the ordinance removed the new department from managerial or administrative supervision. The court found the ordinance invalid. *Hubbard*, 55 Cal. App. 3d at 384. The legal rule we derive from this case is straightforward. The City Council cannot do something by ordinance, “which *duplicates* or *infringes upon* the specific powers or duties assigned by the charter to another department or, generally, to the manager.” *Id.* at 388 (emphasis added).

Similarly, in *Dadmun v. City of San Diego*, 9 Cal. App. 549 (1908), the City Council created by ordinance an Office of Special Prosecutor to handle certain criminal cases, and appointed Mr. Dadmun to fill the position. He prosecuted certain criminal cases, and sued the City for payment when it declined. The Charter then required the City Attorney to prosecute all criminal cases arising from violations of city ordinances. The Court found the actions of the City Council in appointing a special prosecutor to be “unauthorized and void.” *Dadmun*, 9 Cal. App. at 551. The rule distilled from this case: “[T]he city council cannot relieve a charter officer of the city from the duties devolving upon him by the charter and designate another to perform such duties.” *Id.*

Hicks is a case analogous to the current situation. A county board of supervisors tried to transfer about one third of a district attorney’s investigators to the sheriff’s office, in an effort to reorganize investigatory activities. The California Constitution and state laws governed the derivation of authority of the various governmental bodies and officers in the *Hicks* case, as the City Charter does in our case. The laws did not give the board of supervisors control over the district attorney. The laws did give control to the district attorney over the institution of criminal proceedings. The investigation and gathering of evidence was inseparable to that function. The question was whether the board could lawfully require the district attorney to perform some of its investigatory function through the sheriff’s office. The answer was no. The court held that the county legislative body had no power to control the district attorney, a statutory officer, in the performance of a required function “by requiring that he perform his essential duties through investigators who are subject to the control of another county officer.” *Hicks*, 69 Cal. App. 3d at 241. It did not have “authority to transfer control of one officer’s statutory function to another officer.” *Id.* at 244.

In *Scott v. Common Council*, 44 Cal. App. 4th 684 (1996), the Common Council of the City of San Bernardino by budgetary action eliminated the only two investigators in the City Attorney’s Office. The City Attorney sued, claiming the Council had a legal duty to provide the attorney with a sufficient number of investigators to perform his charter-mandated duties. The Court found the Council had acted beyond its budgetary jurisdiction. By eliminating the investigators in the attorney’s office, it had eliminated the attorney’s ability to carry out a mandatory charter duty. *Scott*, 44 Cal. App. 4th at 698. The court found that legislative bodies may not allocate their dwindling supply of funds during hard time funds among competing government needs “by first eliminating mandatory government functions.” *Scott*, 44 Cal. App. 4th at 697.

The question before us is whether the City Council may transfer the functions of the Treasurer's Revenue Audit Division to the City Auditor. We have concluded these functions (consisting of periodic revenue compliance audits or inspections) appropriately meet the Treasurer's express legal duty under the Charter to continuously inspect the records of the businesses remitting the special revenues she must collect, to effectuate that collection. The functions are an integral part of the Treasurer's special revenue collection duties, expressly imposed upon her by the Charter. Under these circumstances, the City Council may not transfer these Charter-required functions from the Treasurer to the City Auditor by ordinance or otherwise.¹⁶

The Revenue Audit Division's functions are also plainly part of City management's functions under the Charter as reformed in 2008. The City Auditor has the particular duty under our Charter to audit such management functions and processes, assessing how well or poorly they are performed. The City Auditor must follow GAGAS, which place great emphasis on auditor independence. Two overarching independence principles are that "(1) audit organizations must not provide . . . services that involve *performing management functions* or making management decisions and (2) audit organizations *must not audit their own work . . .*" GAGAS § 3.22 (emphasis added). Services that "directly support the entity's operations" and impair independence of the auditor *cannot be overcome* by compliance with supplemental safeguards. GAGAS § 3.29. They include services that involve "taking responsibility for basic financial or other records that the audit organization will audit." GAGAS § 3.29(a).

Transferring the functions of the Treasurer's Revenue Audit Division to the City Auditor conflicts with the GAGAS independence principles the Auditor must follow under our City Charter. It risks permanent impairment to the Auditor's independence, which voters just approved by adding sections 39.1 and 39.2 to the Charter. The 2008 restructuring of the Charter separated the City's financial accounting and reporting functions under Mayoral control from the independent Auditor function. This proposed transfer of a management function to an officer who may not perform such function under the San Diego Charter conflicts with the Charter. Accordingly, we conclude that a court would likely determine such action by the City Council to be void. *See Domar Electric*, 9 Cal. 4th at 171.

CONCLUSION

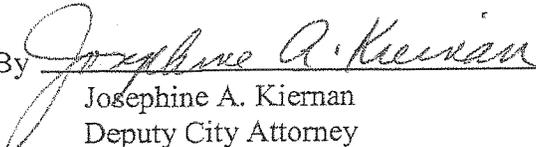
The Audit Committee is tasked with recommending potential budgetary changes to the City Auditor's Office to the City Council for action. The proposal to transfer functions of the Revenue Audit Division from the Treasurer's to the City Auditor's Office would impact the budget of the City Auditor and so the Committee has correctly asked for advice on the legal propriety of the proposal.

Under the requirements of the recently-amended Charter and the facts presented to us, the City Council is legally precluded from transferring the functions of the Revenue Audit Division to the City Auditor. The Charter places an express duty on the Treasurer to maintain a

¹⁶ These cases also tell us that the City Council may not duplicate the Treasurer's revenue audit function in the City Auditor's Department; or require the City Treasurer to exercise this function through the City Auditor's Office.

continuous inspection over special revenues she must collect, in order to effectuate their collection, a traditional management function. Maintaining the authority and independence of the City Auditor is critically important to the public and public officials, and is now required of the City Auditor by the Charter. Attempting a transfer to the City Auditor of a management (collection-of-revenue) function also conflicts with Charter requirements for that office and would likely be found legally invalid.

JAN I. GOLDSMITH, City Attorney

By 
Josephine A. Kiernan
Deputy City Attorney

JAK:jdf:sc

cc: Gail Granewich, City Treasurer
Eduardo Luna, City Auditor
Honorable Mayor Jerry Sanders
City Councilmembers
Andrea Tevlin, Independent Budget Analyst
ML-2010-12

Office of
The City Attorney
City of San Diego

MEMORANDUM
MS 59

(619) 236-6220

DATE: August 12, 2011
TO: Eduardo Luna, City Auditor
FROM: City Attorney
SUBJECT: Review of Opinion Regarding Transfer of Revenue Audit Function

You requested that our Office review the City Attorney Memorandum of Law No. 2010-12 (MOL) dated June 10, 2010, which opined that the City Treasurer Revenue Audit Function cannot legally be transferred to the Independent City Auditor. You have requested further review of the MOL, with the specific inquiry of where the audit authority lies for the revenue recovery, since the function may not be transferred to the Auditor.

I have reviewed the MOL; the Independent Budget Analyst (IBA) Report dated May 7, 2010; the City Auditor memoranda dated June 10, 2010, and May 7, 2010; and the City Treasurer memorandum dated May 10, 2010; along with the pertinent San Diego Charter and Municipal Code sections, and San Diego Administrative Regulations. I conducted a further review of recommendations for, and the role of auditing in public sector governance from the Generally Accepted Government Auditing Standards (GAGAS) and well-known government auditing publications, including the Association of Local Government Auditors and The Institute of Internal Auditors.

After a thorough review of these sources, I have come to the same conclusion. The functions of the Revenue Audit Division of the City Treasurer cannot legally be transferred to the City Auditor's Office.¹ The analysis further supports the current organizational structure wherein the City Treasurer (Treasurer) is responsible for management and collection of City revenue and the Independent City Auditor (Auditor) is responsible for auditing such revenue collections.

¹ For an in-depth analysis on the reasons why City Council may not legally transfer the Revenue Audit Division of the City Treasurer to the City Auditors, please see City Att'y MOL No. 2010-12 (June 10, 2010), entitled "Proposed Transfer of the Functions of the Revenue Audit Division of the Treasurer's Office to the City Auditor's Office."

It is widely-known in the government auditing industry that auditors are required to have organizational independence from the departments they audit. Specifically,

[A]udit organizations must be free from organizational impairments to independence with respect to the entities they audit. Impairments to organizational independence result when the audit function is organizationally located within the reporting line of the areas under audit or when the auditor is assigned or takes on responsibilities that affect operations of the area under audit.

Government Accounting Standards, The United States Government Accountability Office (GAGAS), July 2007, § 3.12. This basic tenet is commonly discussed in heavily relied on government auditing publications.

For example, the Institute of Internal Auditors also emphasizes that the auditor needs to have organizational independence from departments it audits. Specifically, “[a]uditors should have sufficient independence from those they are required to audit so that they can both conduct their work without interference and be seen as able to do so” *Everyday Ethics for Local Officials, The Agency Auditing Function*, Institute for Local Government, December 2009, (quoting *The Institute of Internal Auditors, “The Role of Auditing in Public Section Governance”*). In fact, The Institute of Internal Auditors recommends that: “[t]o preserve their independence, government auditors’ advisory/assistance services should never assume a management role” (“The Role of Auditing in Public Sector Governance,” The Institute of Internal Auditors, Nov. 2006, p.5). Proper governance “requires regular financial and performance reporting *that is validated for accuracy by an independent auditor.*” *Id.* at 7 (emphasis added). Also, the San Diego City Auditor’s (Auditor) May 7, 2010, memorandum recognizes: “Standards specifically state that impairments result when an audit function is organizationally located within the reporting line of the areas under audit or when the auditor is assigned or takes on responsibilities that affect operations of the area under audit.”

Here, the Treasurer’s Office performs a management function in the oversight and collection of revenue for the City. The Treasurer’s Office has the managerial duty, not only to collect revenues on a daily basis, but to establish effective controls and assess risks in its collection efforts. The San Diego Municipal Code (SDMC) requires the Treasurer to collect taxes and also gives the Treasurer audit authority in certain scenarios. For instance, with respect to the Transient Occupancy Tax (TOT), the Municipal Code requires the Treasurer to collect the TOT revenue, to inspect all business records of operators², and “to apply auditing procedures” to determine the amount of such tax for which hotel operators are liable. SDMC § 35.0121. The Municipal Code further provides that “it shall be unlawful to refuse to allow or to permit such audit to be conducted after a lawful demand therefor by the City Treasurer, or the City Auditor *when so requested by the City Treasurer.*” *Id.* (emphasis added). Therefore, the revenue compliance audit performed by the Treasurer’s Office is a management function; required to

² “Operator” means the person who is the proprietor of the Hotel, Recreational Vehicle Park, or Campground assessed the TOT tax. SDMC § 35.0102.

ensure proper collections. The Auditor, on the other hand, is not given such access to independent, revenue-producing entities, unless requested to do so by the Treasurer.

The auditor's role is to provide the oversight, insight and foresight to the managing department. "The Role of Auditing in Public Sector Governance," The Institute of Internal Auditors, Nov. 2006, pp 12-13. The government auditor has the duty to assess and report on the success of these collection efforts conducted by the treasurer. The auditor's job is to provide insight by further assisting management in assessing which programs are working and which programs are not. The auditor should also have the foresight to help departments identify trends and challenges before they become crises. *Id.*

Here, the City Charter only gives the Auditor access to an entity's records for all City contracts with "consultants, vendors, or agencies." San Diego Charter § 39.2. These are entities which voluntarily contract with the City, and generally involve spending City revenue. The Charter, however, does not provide the Auditor with the same access to entities which are required to provide revenue to the City, such as the hotel operators (TOT assessments), franchisees, and lessees.

The City of San Diego currently operates with the same organizational structure recommended by GAGAS and government publications for public sector auditing. The Treasurer has the responsibility to manage the collection of revenue. The Auditor has the authority to audit such collections, just as the Auditor conducts audits on other City departments, to objectively determine whether the departmental reports establish a proper basis for the collection of, accounting for, and depositing of revenues and other resources. *The Agency Auditing Function*, quoting The Association of Local Government Auditors. The Auditor, however, may not perform the management function and may not take on responsibilities that affect the operations of the Treasurer's department. The City's current organizational structure with respect to revenue collection also ensures compliance with the Auditor and Treasurer functions as described in the Municipal Code, and the San Diego Charter at sections 39.1, 39.2, and 45³. Further support for the current structure of the revenue audit function can be found when compared to other jurisdictions. The IBA reported that most cities operate in the same manner as the City of San Diego with respect to revenue compliance audits, or collections, i.e., that a finance or revenue related department performs this function – not the auditor.⁴

To summarize, in addition to the requirements found in state and local laws, Government Auditing Publications recommend that the Auditor should be determining whether programs are effective, not actually managing the collection of revenue.

³ For an in-depth analysis on the functions of the Auditor and Treasurer in accordance with the City Charter, please see the City Attorney MOL No. 2010-12 (June 10, 2010), which remains good law.

⁴ See Independent Budget Analyst Report No. 10-39, dated May 7, 2010, entitled, "Analysis Related to a Proposal to Transfer the City Treasurer's Revenue Audit Program to the Office of the City Auditor."

Therefore, the City Auditor is permitted to perform such revenue audits to determine whether the revenue has been properly collected, in addition to assessing the efficiency and controls of the Treasurer's department, just like the Auditor does for any other City Department(s).

JAN I. GOLDSMITH, City Attorney

By 
Kimberly K. Kaelin
Deputy City Attorney

KKK:jb

MS-2011-10

cc: Honorable Mayor
City Councilmembers
Andrea Tevlin, Independent Budget Analyst
Gail Granewich, City Treasurer

Doc. No. 201243_3