



#332
9-4-07

THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: August 29, 2007

IBA Report Number: 07-80

City Council Docket Date: September 4, 2007

Item Numbers: 332 and 333

Item: Background Information for Item 332 - Report from the Independent Consultant (Stanley Keller) and Item 333 - Response to the SEC

RECAP OF INDEPENDENT CONSULTANT/MONITOR CONTRACT

The purpose of this report is to provide background information for Council and the public with respect to two items on next week's docket that relate to the status of the City's financial reforms. The first item, Item 332, is an information report from Stanley Keller in his capacity as the City's **Independent Consultant** as required by the Securities and Exchange Commission (SEC) in their Order of November 14, 2006. The SEC required that the City retain an Independent Consultant for a period of three years to review and make recommendations regarding the City's policies and internal controls with respect to its financial disclosure functions. A three year contract with Mr. Keller was recommended by the Mayor and approved by Council on January 16, 2007.

This contract also provided for Mr. Keller to serve in the capacity of "**Monitor**" as recommended by the Kroll report that was issued on August 8, 2006. In his role as Monitor, Mr. Keller is to assist with review and implementation of remediation measures as recommended by Kroll. While there is natural overlap between Independent Consultant and Monitor duties, it is important that they be distinct in their execution. Given the crossover of issues, the intent of Mr. Keller serving in both roles was to take advantage of knowledge he has acquired about San Diego's reform efforts in order to achieve efficiencies.

INITIAL REPORT OF INDEPENDENT CONSULTANT TO THE CITY OF SAN DIEGO (Item 332)

The SEC Order calls for the designated Independent Consultant to issue three reports to the SEC as follows: "issue its first report within 120 days after the date of the engagement and the following two reports within 60 days following each subsequent one-year period from the date of engagement." With Mr. Keller's contract with the City

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being executed on or about January 27, 2007, his first report, using that date, was due to the SEC on May 28, 2007. However, Mr. Keller requested of the SEC, and the SEC approved, an extension to June 8, 2007. Mr. Keller indicated he requested an extension in order to allow for items that were underway to be finalized and reflected in the report. Future requests for extension should first be approved by the Mayor and City Council.

Mr. Keller issued his report to the City Council, the Mayor's Office and the City Attorney as well as to the SEC on June 7, 2007. As Mr. Keller did not present his report to the City Council upon its release, this item is docketed so that he can discuss his report in a public forum and respond to questions.

LETTER FROM SEC IN RESPONSE TO THE INDEPENDENT CONSULTANT'S INITIAL REPORT (Item 333)

On Monday, July 23, 2007 Stanley Keller, Independent Consultant, and John Hartigan, the City's outside legal counsel on this matter, received a letter from Kelly C. Bowers, SEC Senior Assistant Regional Director, in response to the Independent Consultant's June 7th Initial Report. Mr. Keller provided the letter to the CFO and the City Attorney's Office the same day he received it, and he suggested that it be provided to the Chair of the Audit Committee. The correspondence was not similarly distributed to the Council President, members of the City Council or the IBA on the 23rd. It was provided to the Chair of the Audit Committee at the end of the week and to the City Council on Monday, July 30th. Timely distribution of important SEC communications is critical to both branches of government, and responsibilities for this should be clarified for the future.

The letter from the SEC requested that additional information be provided on the steps taken by the City to adopt the following items discussed in Mr. Keller's report:

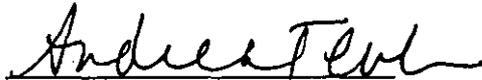
- Finalizing the internal audit function and hiring a qualified internal auditor
- Completing the organization of the Audit Committee and selecting citizen advisors and professional consultants to advise them
- Upgrading to a new financial accounting system
- Reevaluating the roles and accountability of the CFO and the Auditor and Comptroller
- Evaluating the disclosure process and consider moving to a shelf-like disclosure system

The letter stated: "please advise us as soon as possible as to the steps taken by the City to adopt the above recommendations or other alternative methods designed to achieve the same objectives... We are also interested in knowing the estimated timeframe for implementing these recommendations."

Since the letter was addressed to Messrs. Keller and Hartigan, I asked Mr. Keller to clarify whether the response should come from him or directly from the City. Mr. Keller noted that the City should be responding directly "since it is the City's response to my (Mr. Keller's) recommendations." At a special Audit Committee meeting of August 6th, the CFO discussed several points that he suggested be included in a City response. It was also noted at this meeting that this item would be scheduled for full Council discussion on September 4th, 2007 - the first Council meeting following legislative recess. In a letter sent on August 7th, the CFO notified the SEC regarding this schedule. This item has been docketed in order to discuss and coordinate a City response.

The IBA believes that a coordinated response regarding steps taken and planned actions will best convey the City's commitment to be responsive to the items noted in the SEC letter of July 23rd, 2007.

This report is provided for information only.



Andrea Tevlin

Independent Budget Analyst



**OFFICE OF COUNCILMEMBER TONI ATKINS
COUNCIL DISTRICT THREE**

M E M O R A N D U M

DATE: July 30, 2007
TO: Council President Scott Peters
FROM: Councilmember Toni Atkins 
SUBJECT: Request to Docket Report from Independent Monitor

On June 7, 2007, the City's Independent Monitor, Stanley Keller, submitted to the Securities Exchange Commission (SEC) an initial status report on the City's financial management that was required by the SEC within 120 days of Mr. Keller's appointment. While the City Council received copies of the written report, Mr. Keller did not appear before the Council to provide an overview of his report or to answer questions about it.

Today, City Attorney Michael Aguirre made comments at the Council's Audit Committee meeting regarding a response to that report from the SEC that was contained in a July 23, 2007 letter to Mr. Keller and outside counsel John Hartigan. As neither Councilmembers who sit on that committee nor the public had received a copy of the SEC response and the item had not been properly docketed and noticed, discussion of the response and the City Attorney's comments was not permitted.

I request that you place on the City Council docket for a meeting in September, 2007, an oral, in-person, report from Mr. Keller regarding his June 7, 2007 submission to the SEC and the SEC's response. I would also like to request that you ask Mr. Hartigan to be present at the time of Mr. Keller's report. The purpose of my request is to ensure that these matters of vital interest to the Council and the public are fully aired in a properly noticed public meeting.

Thank you for your consideration in this matter.

cc: Honorable Councilmembers
Mayor Sanders
City Attorney Michael Aguirre
Independent Budget Analyst Andrea Tevlin

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SECURITIES AND EXCHANGE COMMISSION
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July 23, 2007

VIA FACSIMILE AND U.S. MAIL

John F. Hartigan, Esq.
Morgan, Lewis & Bockius LLP
300 South Grand Ave., 22nd floor
Los Angeles, CA 90071-3132

Stanley Keller, Esq.
Edwards Angell Palmer & Dodge LLP
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Boston, MA 02199-7613

Re: City of San Diego Bond Offerings (LA-2842)

Dear Messrs. Hartigan and Keller:

I am writing in regard to the Commission's November 14, 2006 cease-and-desist order against the City ("the Order") and the "Initial Report of Independent Consultant" ("the Initial Report") issued to the City of San Diego on June 7, 2007. The Order provided that within 120 days after the date of engagement, Mr. Keller, as the Independent Consultant, would submit a report to the City and the Commission that described the review performed and the conclusions reached and any recommendations deemed necessary to make the policies, procedures, and internal controls adequate and address the deficiencies set forth in Section III.D. of the Order.

Given the short amount of time and the complex nature of the City's issues, the Initial Report contained few recommendations and did not include deadlines for implementation of the recommendations. We understand through our discussion with Mr. Keller that his next report will be more complete in making more complete, specific, and concrete recommendations and setting deadlines.

We note that the Initial Report did contain the following recommendations:

- The City must finalize the internal audit function and hire as soon as possible a qualified internal auditor;

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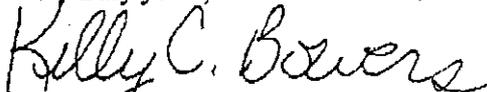
John F. Hartigan, Esq.
Stanley Keller, Esq.
July 23, 2007
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- The Audit Committee should complete its organization as quickly as possible by selecting citizen advisers and professional consultants, as necessary, to assist the Audit Committee in discharging its responsibilities;
- The City should upgrade to a more modern and reliable financial accounting system so as to ultimately improve financial reporting;
- The City should re-evaluate the role and accountability of its Chief Financial Officer and consider having the same person serve as the Chief Financial Official and Auditor and Comptroller; and
- The City should continue evaluating the disclosure process and consider whether moving toward a shelf-like disclosure system would be appropriate.

The Order provides that the City will take all necessary and appropriate steps to adopt, implement, and employ the Independent Consultant's recommendations or the City's alternative methods designed to achieve the same objective or purpose as that of the Independent Consultant's recommendations. Please advise us as soon as possible as to the steps taken by the City to adopt the above recommendations or other alternative methods designed to achieve the same objectives. We are also interested in knowing the estimated timeframe for implementing these recommendations.

Please feel free to call me if you have any questions.

Very truly yours,



Kelly C. Bowers
Senior Assistant Regional Director

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Initial Report of Independent Consultant

to the

City of San Diego

June 7, 2007

Stanley Keller

Edwards Angell Palmer & Dodge LLP

City of San Diego
Independent Consultant Initial Report

I. Introduction

This is my Initial Report as Independent Consultant to the City of San Diego (the "City") in accordance with the Cease-And-Desist Order of the United States Securities and Exchange Commission (the "SEC") dated November 14, 2006 (the "SEC Order"). I became Independent Consultant under the Agreement between the City of San Diego and Edwards Angell Palmer & Dodge LLP for Independent Consulting Services dated January 16, 2007 (the "Agreement"). As provided in the Agreement and the SEC Order, this Initial Report describes my review and assessment of the City's policies, procedures and internal controls regarding (i) its financial and other disclosures, (ii) the hiring of internal personnel and external experts for disclosure functions, and (iii) the implementation of active and ongoing training programs to educate appropriate City employees regarding compliance with disclosure obligations, and my conclusions and recommendations with respect to these matters. The SEC Order provides for subsequent reports to be delivered annually after the first and second anniversaries of my appointment.

The Agreement, as permitted by the SEC Order, also provides for me to serve as Independent Monitor to the City as contemplated by the Report of the Audit Committee of the City of San Diego issued on August 8, 2006 (the "Kroll Report") to oversee and assist the City in implementing the recommendations of the Kroll Report. Because the two roles are so closely related and complementary, this report covers both activities.

A word about limitations so that the context for this report can properly be understood and the report appropriately evaluated:

- Because of the relatively short time since my appointment, there are limits to what could realistically be done. Although there has been measurable progress and I can make some initial assessments, the process of assessment and evaluation is ongoing as I familiarize myself with the City, its processes and its personnel. As a consequence, it would not be appropriate for me to reach definitive judgments at this stage of the effort, and I refrain from doing so. Nevertheless, I do make some observations regarding issues and concerns based on my experience to date.
- The City has not accessed the securities markets in a public offering for some time and has not prepared a recent official statement. Therefore, there has not been an opportunity to participate in and observe the City's disclosure process and assess the adequacy and quality of its disclosures in the context of a public securities offering. This is expected to happen before my next report.
- Moreover, a significant portion of my activities for the City to date has, as described below, been devoted to assisting the City to put in place structures, controls and procedures to help ensure the quality of its disclosure and the

reliability and transparency of its financial reporting. Thus, there has been relatively less time for observation, assessment and evaluation.

- My focus has been on the City's ongoing efforts and future compliance. My role is not to revisit or replicate the extensive internal and forensic investigations that have taken place at great cost to the City. Although an understanding of the past is important for an appreciation of the present situation and a clear view of the pitfalls that need to be avoided going forward, I have taken the findings of the prior investigations as a given for purposes of my activities without reaching judgments (recognizing that some of these findings may be in dispute and that there are ongoing proceedings in which their validity may be assessed).

In the 1970s and 1980s, a disclosure model comparable to the model of full and fair disclosure that was developed for the corporate securities world under the SEC's registration system was thrust upon the municipal securities world, resulting in SEC Rule 15c2-12 and an increased focus on antifraud enforcement. Rule 15c2-12 mandates that an underwriter obtain from the issuer and review a final official statement containing specified information and reasonably determine that the issuer has undertaken to provide continuing disclosure of certain information in order for the underwriter to participate in a municipal securities offering. As a corporate securities lawyer with some involvement in municipal securities because of my firm's practice in that area, I was able to contribute to the development of that municipal securities disclosure regime.

The current post-Sarbanes – Oxley world places heavy emphasis on the governance structures, internal controls and disclosure processes and systems of public companies to ensure the adequacy of financial reporting and disclosure. In this environment, we are now presented with a parallel opportunity to bring similar structures, controls, processes and systems to municipal entities, but adapted to fit their unique nature and needs. Thus, although my assignment as Independent Consultant is focused on the City, and in particular on its compliance with the SEC Order, there is an opportunity to help create a model for other governmental entities. This opportunity has been embraced by key officials within the City, including its Mayor, who view the difficulties the City has experienced as an opportunity not merely to *comply with the SEC Order* but to *create a framework that can serve as such a model*, utilizing the roadmap set out in the Kroll Report.

II. Summary of Historical Context

The SEC Order resulted from the SEC's investigation into whether the City violated the antifraud provisions of the federal securities laws in connection with its offer and sale of over \$260 million in municipal bonds in 2002 and 2003, its filing of information pursuant to its continuing disclosure obligations with respect to its outstanding bonds and notes, and its annual presentations to the rating agencies. In particular, the SEC found that, in connection with these activities, City officials knew or were reckless in not knowing of the failure to disclose the severe difficulty the City faced with respect to funding its future pension and retiree health care obligations. The Kroll Report also found that the City knowingly violated federal and state legal

requirements regarding the allocation of costs to residential and industrial users of its wastewater sewer system.

According to the SEC Order:

- During the relevant time period, the City engaged in several disclosure-related activities. The City conducted five municipal bond offerings during 2002 and 2003, totaling over \$260 million in face value. In connection with each of these offerings, City officials assisted with the preparation of offering documents, namely the preliminary official statement and the official statement. These documents contained information relating to the City's pension and retiree health care obligations in appendices A and B, which appendices City officials were directly responsible for drafting and updating.
- Further, in 2003 the City prepared and filed annual continuing disclosures relating to \$2.29 billion in outstanding City bonds and notes. These disclosures included information relating to the City's current fiscal state, including the state of its pension obligations. City officials were responsible for ensuring that these disclosure filings contained current and accurate information.
- Finally, during the relevant time period, the City made yearly presentations to the rating agencies both with respect to specific bond offerings and to update the agencies on the City's general credit. The agencies specifically requested that the City address its pension plan in these presentations, as this information directly affected the City's bond ratings. These presentations were prepared and presented by City officials.
- In connection with these disclosure undertakings, the City provided information relating to its pension and retiree health care obligations. Such information, however, did not include disclosure of the gravity of the City's financial problems with respect to funding these obligations. In particular, the City faced substantial and growing pension and retiree health care liabilities, primarily as a result of the City's intentional under-funding of its pension plan over a number of years, the *granting of additional retroactive pension benefits*, its use of pension fund assets to pay for those additional benefits, and the pension plan's unexpectedly low investment earnings.

When the City eventually disclosed these liabilities in fiscal 2004, the credit rating agencies lowered the City's credit rating. The City also was unable to obtain audited financial statements. The SEC, in turn, conducted an investigation into the matter. The SEC found that the City's failure to disclose information regarding the current funding of its pension and retiree health care obligations, the future funding of those obligations, and the City's ability to pay those future obligations constituted a violation of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, which prohibit the making of any untrue statement of material fact or omitting to state a material fact in the offer or sale of securities.

III. Overview of Process Followed

Following my appointment, I began a series of meetings with relevant City officials, City personnel and others, as well as a review of various documents to gain a better understanding of the City, its methods of operation and its key issues. I was assisted in these activities by lawyers and other personnel in my law firm, most notably Walter St. Onge, an expert in municipal finance law. Among the persons with whom I met were the following:

- Mayor and members of his staff
- Chief Operating Officer
- Chief Financial Officer
- President of the City Council
- Chair of the Council's Audit Committee and other members of that Committee
- Independent Budget Analyst
- City Attorney
- Deputy City Attorney for Finance and Disclosure
- Director of Financial Reporting
- The City's consultant responsible for internal controls remediation
- The City's outside disclosure counsel
- Representatives of KPMG, LLP, the City's outside auditor for fiscal 2003
- Representatives of Macias, Gini & O'Connell LLP, the City's outside auditor for years after fiscal 2003
- Members of the recently appointed City Charter Revision Committee
- Officials of the San Diego City Employees' Retirement System ("SDCERS")

Among key documents reviewed were:

- The Kroll Report
- Responses of the Mayor and others to the Kroll Report
- Report on Investigation issued by Vinson & Elkins LLP on September 16, 2004 (the "Vinson & Elkins Report")
- The SEC Order
- Disclosure Practices Working Group Ordinance and related Rules and Regulations of the Group and Disclosure Controls and Procedures
- 2003 Comprehensive Annual Financial Report ("CAFR")
- Mayor's Proposed 2008 Budget and responses of various officials to that budget
- Various City Attorney Reports and Memos
- Various Independent Budget Analyst Reports

Early on, I determined that in order to perform my responsibilities I would need to have independent governmental accounting and auditing expertise available to me. To this end, I have retained Rod LeMond of McGladrey & Pullen LLP based in Riverside, California to assist me. McGladrey & Pullen is a leading national accounting and auditing firm with recognized expertise in governmental accounting and auditing. They have an office in San Diego. Mr.

LeMond is a partner with more than 26 years of experience in public accounting with extensive experience in auditing governmental entities and providing consulting services.

IV. Actions Taken

Both prior to my engagement (and indeed prior to the SEC Order) and subsequent to my engagement, with my participation and assistance, the City has taken a number of steps designed to strengthen its governmental structure, disclosure processes and control systems, each of which should contribute to more reliable financial reporting and disclosure. Further actions are in progress as described below.

Actions Prior to My Engagement. Most importantly, the voters approved on a trial basis a strong Mayor form of government to replace the City Manager form of government under which the City Manager was chosen by the City Council. With this change came the appointment of a professional Chief Financial Officer. These changes have centralized and focused responsibility and accountability for the City's financial affairs. The City also replaced a number of officials and retained new outside advisors.

At the same time, the City Council created an office of Independent Budget Analyst ("IBA") that provides important assistance to the City Council in the performance of its legislative function and serves as a key check and control on the actions of the Executive Branch.

Another component of the City's governmental structure that performs an essential role in the City's compliance with legal requirements and serves as another control point is the City Attorney's Office led by an independently elected City Attorney. The capabilities of the City Attorney's Office in the disclosure process have been significantly enhanced by the appointment of a Deputy City Attorney for Finance and Disclosure with background and experience in municipal finance and municipal disclosure.

As described below, the City took a number of steps to improve its disclosure process, including creating a Disclosure Practices Working Group ("DPWG") and adopting Disclosure Controls and Procedures ("DCP"), requiring senior officials to certify the accuracy of the City's disclosures and providing for an annual evaluation and report on the City's internal financial controls by the City's Auditor and Comptroller. The City also retained John M. McNally of Hawkins Delafield & Wood LLP as outside disclosure counsel.

Also, shortly before my engagement, the City Council formed an Audit Committee with three Council Members to assist the City Council in providing oversight of the City's financial reporting and disclosure. Although in existence at the time of my engagement, the Audit Committee had not yet been fully organized.

Actions Since My Engagement. The following actions have been taken since my engagement, in many cases with my active involvement and assistance. These actions were largely to implement the recommendations in the Kroll Report and meet the requirements of the SEC Order.

- * • Audit Committee. The Audit Committee has been organized through the adoption of a revised ordinance and approval of an Audit Committee Charter, which is included as part of the ordinance. A copy of the ordinance, including the Charter, is attached as Exhibit 1. The stated purpose of the Audit Committee is to, among other things, provide independent legislative oversight of the City's accounting and financial reporting and disclosure processes, internal controls over financial reporting, internal financial audit function and audit of the City's financial statements, including retention of the independent outside auditor.

As noted above, the Audit Committee consists of three Council Members, one of whom serves as chair. This is at variance with the Kroll Report recommendation calling for an audit committee with two citizen members with financial expertise selected by the Mayor and one Council Member. The variation is due, in part, to a finding by the City Attorney that the Kroll Report's suggested makeup would not be consistent with the City Charter in view of the legislative function the committee would perform.

The current makeup of the Audit Committee has the advantage of being comprised of members of the legislative body that are independent of City management, which is a model used by a number of municipalities with audit committees. Its disadvantage is that the members, as elected officials, do not necessarily have the financial expertise that is desirable for performance of the Committee's duties.

To address this disadvantage, the ordinance and related Audit Committee Charter contemplate appointment of an ad hoc advisory group of at least three persons with financial or accounting expertise to assist the Audit Committee, two appointed by the Committee, one appointed by the Mayor and any others appointed jointly. The selection of the advisory group is in process. In addition, the Audit Committee is planning to retain a professional with auditing or accounting expertise to assist it in the performance of its duties.

The future composition and role of the Audit Committee is one of the structural issues on the agenda of the Charter Revision Committee as discussed below. The Charter Revision Committee was appointed to make recommendations on proposed City Charter revisions which the voters will likely be asked to act on in June 2008.

- * • Internal Audit Function. An effective and independent internal audit function is a critical component of a reliable control structure for a major city like San Diego. The City does not now have an independent internal audit function that operates effectively to cover the full range of activities required of that function. The City Charter creates a position of Auditor and Comptroller who acts under the direction of the Mayor. The Auditor and Comptroller is responsible for the accounting, financial reporting and internal audit functions. Under this structure, *the essential elements for an independent internal audit function, namely*

separation of functions and direct reporting to an independent oversight body, have been missing. In addition, the City's financial management has transferred personnel from internal auditing to preparation of the City's delinquent financial reports.

The City has taken some steps towards establishing an independent internal audit function within the confines of the existing City Charter. The Mayor, in cooperation with the Audit Committee, the IBA and the City Attorney, has issued a Statement of Operating Principles (the "Statement") designed to establish an independent internal audit function prior to revision of the City Charter. The Statement, which is attached as Exhibit 2, provides for appointment of a qualified internal auditor as a separate position in the Auditor and Comptroller's office and directs that the internal auditor communicate directly with the Audit Committee periodically and more frequently as necessary. The Audit Committee is to have a role in the selection process and in any termination of the internal auditor, thus enhancing that person's independence. The result of these measures is an arrangement consistent with a dual reporting model in which the internal auditor is part of management for administrative purposes and works with management but has a direct communication line and responsibility to the Audit Committee as the oversight body independent of financial management.

Recognizing the City's current priorities on financial reporting and the anticipated interim nature of the arrangement, the Statement specifically limits the internal auditor's focus to financial reporting matters and thus excludes operating and performance audits, which are an important component of a governmental internal audit function. Although the internal audit function created under the interim arrangement has these limitations, the matters authorized to be covered are a critically important part of an internal audit function and significantly improve upon the structure previously in place. Moreover, these limitations are applicable only under the interim arrangement and there is recognition that the internal audit function thereafter will embody the full range of functions appropriate for a major city. The exact nature of the independent internal audit function under a revised City Charter is on the Charter Revision Committee's agenda as discussed below.

The Mayor has taken an initial step of appointing an acting internal auditor from within the City's financial staff and, working with the Audit Committee, has begun the search process for a qualified professional to serve as internal auditor during the interim period. This person is expected to be in a position to succeed to the independent internal auditor position to be created by the Charter revision. Although these desirable steps have been taken, it is important that the City reestablish a fully functioning internal audit operation as quickly as possible.

- Financial Reporting. Because of its compliance problems, the City was unable to obtain and issue its financial reports for the fiscal year ended June 30, 2003 and for subsequent periods. With the assistance of the Audit Committee and others and as a result of the efforts of the City's financial management, the City achieved

a milestone in mid-March 2007 with the completion of its 2003 CAFR. The completion of the 2003 CAFR permits the preparation and audit of the CAFR for 2004 and subsequent years. The 2004 CAFR has just been completed and the CAFRs for subsequent years are expected to follow on a reasonable schedule. The completion of these financial reports to bring current the City's financial reporting should put the City in a position to reaccess the public securities market.

In connection with the 2003 CAFR, the City established a process for the review of the 2003 CAFR by the Audit Committee, the Audit Committee's recommendation to the City Council that the 2003 CAFR be received and filed, and the City Council's receipt and filing of the CAFR. This process is attached as Exhibit 3. A process is also being established for future review and action on subsequent CAFRs. As part of this process, the members of the Audit Committee and other Council Members were advised of their responsibilities in reviewing City CAFRs in a memorandum dated May 14, 2007 from the City's outside disclosure counsel. A copy is attached as Exhibit 4.

The Audit Committee has reviewed the 2003 CAFR with financial management and the outside auditor, KPMG, and voted to recommend to the City Council that it receive and file the 2003 CAFR. The City Council voted on June 5 to receive and file the 2003 CAFR. The Audit Committee and City Council are scheduled to act on the 2004 CAFR in the near future.

- Disclosure Practices Working Group. In October 2004, before the changes in the City's government, the City formed a Disclosure Practices Working Group to assist the City in complying with its disclosure obligations. The DPWG adopted rules for its operation and Disclosure Controls and Procedures to implement a disclosure control process.

In accordance with a Kroll Report recommendation, the City revised the composition of the DPWG to reflect the changes in the City's governance structure, to focus responsibility with those charged with exercising that responsibility and to adopt changes, including designating a Disclosure Coordinator, so that the DPWG can most effectively contribute at an operational level to the City's disclosure process. The revised DPWG ordinance is attached as Exhibit 5. This is an initial step in reviewing the operations of the DPWG and the DCP so that the DPWG continues to perform its vital role as a check and balance as part of the City's disclosure control process and to enable it to contribute operationally to the quality of that disclosure. As part of the DCP, the role of the Audit Committee and City Council in the disclosure process, in particular in connection with the City's CAFRs, is being defined as discussed above.

- Improper Influence Ordinance. In accordance with another Kroll Report recommendation, the City has prepared a form of ordinance making it a violation of law, with appropriate sanctions, for any City official or employee to improperly

influence the outside auditor or other professionals in connection with the preparation of the City's financial statements and the City's financial reporting. The ordinance has been patterned after Section 303 of the Sarbanes-Oxley Act and SEC Rule 13b2-2. The ordinance is expected to be presented to the City Council for approval in the near future.

V. Training

The DPWG is charged with specified responsibilities to "ensure the compliance of the City (and the City Council, City officers, and staff in the exercise of their official duties) with federal and state securities laws and to promote the highest standards of accuracy in disclosures relating to securities issued by the City." These responsibilities include, among others, ensuring that City staff receive "appropriate training" regarding the City's disclosure controls and procedures. In addition, the City Council directed the IBA to develop a training program for members of the City Council.

The DPWG has implemented a training program under the auspices of the City's outside disclosure counsel, John McNally of Hawkins Delafield & Wood LLP and Mark Blake, Deputy City Attorney for Finance and Disclosure. Mr. McNally and Mr. Blake also assisted the IBA with the training program for the City Council. Three sessions have been held - March 5 for the City Council, April 25 for the Mayor and Executive Staff and April 26 for City employees. Each session lasted approximately one and a half to two hours. The sessions consisted of a presentation from Mr. McNally with assistance from Mr. Blake. Mr. McNally prepared a PowerPoint presentation, copies of which were provided to each attendee, together with the DPWG ordinance and the DCP. I reviewed and commented on the material presented by Mr. McNally and Mr. Blake. I also discussed the City Council training program with the IBA.

In the training sessions, Mr. McNally first examined the various contexts in which City disclosure occurs - primary offering disclosure, secondary market or continuing disclosure and other statements or releases "reasonably expected to reach investors and the trading markets." Mr. McNally then discussed the standards that apply as established under the federal securities laws applicable to City disclosure, including the Rule 10b-5 antifraud provisions. Finally, he reviewed the measures adopted by the City to date to improve its internal procedures and processes to ensure the adequacy of its disclosures. These include the DPWG ordinance adopted by the City Council and the DCP adopted by the DPWG.

The sessions provided a thorough review of the circumstances under which the City makes disclosure, the standards by which any such disclosure will be judged and the steps the City has taken to improve its disclosure practices. They provided a helpful primer to City officials and staff regarding the City's disclosure responsibilities, as well as their own individual responsibilities and the role played by other participants in this process. The material should serve as a useful ongoing resource to the City.

The City Council training session was broadcast live on the City's web site, www.sandiego.gov, and is maintained in the City Council's video archives, also accessible on the City's web site. The City employee session was also videotaped. Accordingly, this

information can be revisited by those who participated in the training sessions and readily accessed by new employees and others who have or may have potential disclosure-related responsibilities.

Additionally, on April 9, a second training session was held for the City Council on municipal accounting and understanding municipal financial statements. At that session, Jim Godsey of Macias Gini & O'Connell LLP, independent accountants with recognized municipal accounting expertise, gave a presentation using the City's annual financial statements as a model. Additional training sessions for the City Council are being planned.

VI. Planned Actions

The actions that have been taken are a good beginning, but only a beginning, and there is much left to be done. The following are some of the planned actions, both by the City to implement the Kroll Report recommendations and comply with the SEC Order and by me as part of my engagement:

- As noted above, I will be conducting ongoing analysis and observation of the City's disclosure processes and practices, including review of the substantive procedures, operations and effectiveness of the DPWG and DCP with a view to improvements that will make them work more effectively and efficiently. As an example, it should be possible to place more emphasis on the preparation and related diligence relating to the City's CAFRs and other ongoing reporting so that the City can go to market with offerings more promptly (this is analogous to the shelf registration system for larger public corporations). A good foundation for this approach has been established by the procedures being approved by the Audit Committee for reviewing the City's CAFRs described above. As the City prepares to reenter the public securities market, it will be appropriate for me to participate in the offering disclosure process in order to be in a position to observe and report on how it functions.
- Review of the City's financial accounting systems will be an ongoing effort, for which I plan to use the resources of McGladrey & Pullen. A modern, reliable financial accounting system is a fundamental predicate to reliable financial reporting. Nevertheless, the City has been operating with an antiquated system designed for a much smaller, less complex enterprise. The City is engaged in a Business Process Reengineering (BRP) project designed to improve the City's management systems, create efficiencies and reduce costs. Related to this, the City is planning to install a new Enterprise Resource Planning (ERP) system to integrate the City's information and processes into a unified system. These changes will impact the financial accounting systems and should produce significant improvements. Therefore, by necessity an evaluation of the City's financial accounting systems will have to be done over time.
- The Yellow Book Report issued by KPMG in connection with its audit of the City's fiscal 2003 financial statements confirmed the material weaknesses in the

City's internal controls, including its internal controls over financial reporting, identified in the Kroll Report and the Vinson & Elkins Report. The City is working on remediation of the deficiencies and weaknesses and is making some progress, but there is much more progress that will need to be made before the City is able to report that its internal controls over financial reporting are effective. Part of the City's remediation plan is dependent upon installation of the new ERP system. The schedule for accomplishing this has been delayed, which in turn delays completion of the remediation. The Kroll Report recommended that an outside audit of the City's internal controls be undertaken in connection with the June 30, 2008 fiscal year-end audit. The City's financial management has suggested that this audit be deferred until the ERP system is in place inasmuch as it would be inefficient and inconclusive to audit the City's internal controls before the remediation measures, including the new ERP system, are in place. This is an understandable request and a full internal control audit may not make sense at this time. It is imperative, however, that the City make progress in improving its internal controls over financial reporting as rapidly as feasible, and it may be possible to undertake interim external checks to help assess and accomplish this objective short of a full audit. I plan to further explore these possibilities. In addition, with the assistance of McGladrey & Pullen, I am evaluating whether the City is devoting sufficient resources to remediation, and I expect to make recommendations on this in due course.

- As described above, the City has successfully begun its training program for the City Council, City officials and City employees. Additional training programs are planned for the City Council. Training is a key component of any compliance plan. I will monitor these training programs, along with follow-on programs for City officials and employees and comment on them in subsequent reports.
- The City is in the midst of its fiscal 2008 budget process. An effective budget process with clearly defined goals, realistic assumptions and a commitment to living within available resources is key to fiscal responsibility. I will be observing the budget process to see if these criteria are met.
- The budget process deals with an annual period, but responsible financial planning requires a longer-term perspective. As recommended by the Kroll Report, the Mayor issued his Five-Year Financial Plan. The quality of this plan and its annual update will be a subject of future evaluation.
- As noted above, the City's information and control systems are outdated and at best only partially effective. The City has embarked on a program to improve these systems through its BRP project and installation of a new ERP system. I plan to monitor the progress of these efforts, with the assistance of McGladrey & Pullen, to ensure that they are being accomplished timely and effectively, with the commitment of the requisite resources.

- The City has in place a whistleblower and hotline complaint system. The Audit Committee Charter provides for establishing procedures for the Audit Committee to receive complaints regarding internal financial control or for financial auditing matters and for confidential, anonymous concerns regarding questionable financial or auditing matters. In addition, the proposed improper influence ordinance would make it unlawful for any City official to retaliate or threaten to retaliate against any City employee who reports any suspected financial impropriety. I plan to monitor the operation of these systems. I also plan to review the City's existing conduct code and recommend whether a more comprehensive code of conduct, particularly as it relates to financial reporting and disclosure, is desirable.
- The operations of SDCERS was a significant contributing factor to the City's problems that resulted in the SEC Order. The methodology for actuarially determining the City's pension and post-retirement health benefits liabilities, the unfunded liability amounts and the required annual contribution, and the controls in place for testing these, are key factors in properly dealing with the City's liabilities and resulting disclosures. I concur with others that the so-called "waterfall" using "surplus earnings" for additional retiree benefits should be eliminated from the City's municipal ordinances. My examination of these matters and evaluation of the relationship between the City and SDCERS has just begun and will be reported on in a subsequent report.
- Like SDCERS, the City's other component units and related and affiliated entities are a material part of the City's financial reporting and disclosure. I plan to review and evaluate these component units and entities in the coming months.
- The Audit Committee has an important role in the City's compliance efforts by providing independent oversight of the City's financial reporting and disclosure and assisting the City Council perform its legislative function. Although the Audit Committee is now in operation, it is still developing its procedures and defining its role. For example, it is in the process of hiring a qualified accounting/auditing professional to assist the Committee in its work and it has on its agenda appointing the ad hoc advisory committee members with financial management and accounting expertise contemplated by its Charter to assist the Committee. I plan to work with the Audit Committee as it continues to organize and perform its oversight assignment.
- The City is also in the process of hiring a qualified professional internal auditor under the interim arrangement established by the Statement that is designed to create an effective independent internal audit function which the City is now lacking. I intend to monitor this effort and then to work with the internal auditor who is hired to develop the internal audit function contemplated by the Statement.
- Both the Audit Committee now in place and the internal auditor position under the Statement can be viewed as interim arrangements pending Charter revision,

likely to occur in June 2008. I plan to work with the Charter Revision Committee on these matters to the extent they relate directly to the City's financial reporting and disclosure and its internal controls. These matters include, in addition to the overall governmental structure, the composition and role of the Audit Committee and the creation of an independent Internal Auditor position (called the "Auditor General" in the Kroll Report).

- Proper recognition of loss contingencies, including those from litigation and workmen's compensation claims, is an important part of financial reporting. I will be reviewing, with the assistance of McGladrey & Pullen, the adequacy of the City's claims management and case management systems and related processes for handling contingencies to assess whether they are adequate for financial reporting purposes.
- An important part of any enterprise's management system for ensuring adequate disclosure is a process to assess and manage risk and identify future trends and uncertainties that could affect the City's financial position. Like many municipal entities, the City does not have effective risk assessment and management processes in place to achieve these goals. I plan to work with the City's financial management to establish these processes.

The objectives of these activities, as outlined in the Kroll Report, are to provide enhanced accountability, greater transparency, increased fiscal responsibility and independent oversight. The ultimate goal is not just to comply with the obligations undertaken by the City in the SEC Order but to create a model of municipal fiscal integrity and quality financial reporting and disclosure that is supported by effective processes, procedures and control systems to ensure achievement of these objectives.

VII. Observations

The City's past compliance failures were so pervasive, its controls and systems so weak and its commitment to fiscal responsibility so undefined, that it will take an intensive and sustained effort, bringing to bear dedicated resources, to overcome these deficiencies. Nothing less than a change in culture from, as described in the Kroll Report, a "culture of expediency" to a "culture of compliance" will be required. Even this will not be enough unless there is a willingness by each of the sectors within the City government to work together to accomplish shared objectives. In addition, there must be the political courage, leadership and will to face up to the reality that the City cannot continue to live beyond its means and pay for past sins while maintaining service levels without additional revenues. City officials express their recognition of this reality but it remains to be seen whether that will be translated into action.

The following are some specific challenges facing the City:

- Even with the best of intentions, full and fair disclosure becomes a challenge when there are fiscal difficulties. Especially in an intensely political environment, there could be a temptation to mask the problems and gloss over risks. A sound

and responsible fiscal situation is the best assurance of promoting quality disclosure. The City faces the challenge of bringing its fiscal house in order and putting the problems of the past behind it.

- The City is still adjusting to its new strong Mayor form of government and seeking to strike the right balance among the different governmental groups. Although checks and balances are an important part of a governmental system and each group within the City government has its own important role to play, a failure of the separate governmental groups to work together constructively would jeopardize the City's ability to make progress and address tough issues.
- The proper governmental structure, including whether to continue the strong Mayor form of government beyond the current trial period, is on the agenda of the Charter Revision Committee. An issue for that Committee will be to determine the optimum alignment of the different groups within the City government to ensure that the right checks and balances are in place while at the same time giving the City officials charged with running the City's affairs the necessary authority to do their job with the corresponding accountability.
- The Kroll Report identified as a needed reform strengthening the role and accountability of the City's Chief Financial Officer because focused accountability for fiscal decision-making and disclosure is an important part of a reliable financial system. The City's past problems are, in part, attributable to the absence of clear responsibility and accountability. However, this strengthening of authority also must be balanced with appropriate controls that effectively serve their purpose and do not undermine either the necessary authority or the related accountability. The City needs to be mindful of this tension as it builds its control structure. As an example, financial management responsibility under the current strong Mayor form of government should be centered in the Chief Financial Officer, who should be held accountable as such. It therefore would make sense for the Chief Financial Officer and Auditor and Comptroller titles to be held by the same person, given the CFO-type duties assigned to the Auditor and Comptroller in the City Charter. Combining these roles is facilitated by the Statement described above that establishes an independent internal audit function, thereby putting in place an effective control structure pending revision of the City Charter to separate the Auditor and Comptroller financial management functions and the internal auditor function as discussed elsewhere in this report.
- Because the City's internal controls historically have been weak and its information systems antiquated, a huge effort is needed to remedy them. It remains to be seen whether the City is devoting sufficient resources to this effort. Assessing whether adequate progress is being made and whether more resources are needed should be part of the Audit Committee's ongoing oversight activities.
- The Audit Committee should complete its organization as quickly as possible by selecting citizen advisers with the required expertise as contemplated by its

Charter and hiring a professional consultant, in each case to assist the Committee discharge its responsibilities. The Charter Revision Committee will have to consider the appropriate composition of the Audit Committee going forward in order to achieve the required independence from financial management, the legislative body representation that is desirable and the necessary accounting and auditing expertise that will allow the Audit Committee to best fulfill its role as an effective control to ensure reliable financial reporting.

- The City must complete as soon as possible the process of hiring a qualified internal auditor in order to establish an effective independent internal audit function as provided for in the Statement without waiting for City Charter revision. The City also should begin planning for the internal audit function following Charter revision that will encompass the full range of internal audit operations and should consider moving in that direction, pending the availability of resources, even before Charter revision. The Charter Revision Committee will have to evaluate the best model to adopt in creating an independent internal audit function, for example, whether to provide for an "Internal Auditor" under a dual reporting model as contemplated by the Statement or to move in the direction of a separate inspector general-type auditor, whether appointed or elected.
- Further revisions to the processes of the DPWG, including the DCP, may be desirable to streamline its operations and add to its effectiveness, not just as a check and balance, but as a resource to improve the quality of the City's disclosures through analyzing relevant issues and reaching considered judgments. In this connection, it will be desirable for the City to consider whether to move toward a more shelf-like disclosure system, similar to that used by larger private issuers, as a way to permit accessing the capital markets in a timely and efficient manner in order to achieve savings for taxpayers and ratepayers.

VIII. Final Words

The City has taken meaningful action to address the problems of the past and to begin to put control structures and procedures in place. However, much more must be done and it remains to be seen whether the City will be successful in implementing the actions already taken and completing the significant remediation still necessary. That success will depend upon the City's leadership having the will to face up to the hard fiscal realities confronting the City, upon the several groups within the City government operating together to create a culture of compliance rather than one of convenience and disharmony that prevents moving the City forward, and upon the City having available and committing the proper resources, both in terms of quality and quantity, to develop and apply the requisite internal control structures and address the City's problems.

I close on a personal note. I have found my assignment challenging but more importantly rewarding. At the time of my appointment, I said that I looked forward to working *with* each group within the City government and pledged to operate objectively and independently. I have appreciated being able to work with each of the groups to take the various actions described in

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this report that are designed to improve the City's control systems and enhance the quality of the City's disclosure and financial reporting. I hope, at the same time, I have demonstrated my objectivity and independence. This is the beginning of a journey to restore the City's credibility and create a model for others to emulate. It is a journey in somewhat uncharted waters because what the City is trying to accomplish has not been done to the same extent before. I look forward to continuing that journey working closely with the City's officials and reporting periodically on the results in accordance with the SEC Order and the Agreement with the City.

Respectfully submitted,

A handwritten signature in cursive script that reads "Stanley Keller".

Stanley Keller
Independent Consultant

June 7, 2007

REQUEST FOR COUNCIL ACTION
CITY OF SAN DIEGO

1. CERTIFICATE NUMBER
(FOR AUDITOR'S USE ONLY)

TO: **001967**
CITY ATTORNEY

2. FROM (ORIGINATING DEPARTMENT):
Council President Scott Peters

3. DATE:
August 24, 2007

4. SUBJECT:
In the Matter of the First Report to the SEC by the San Diego Independent Monitor dated June 7, 2007

5. PRIMARY CONTACT (NAME, PHONE, & MAIL STA.)
Christina Cameron (66611/10A)

6. SECONDARY CONTACT (NAME, PHONE, & MAIL STA.)
Woo-Jin Shim (66611/10A)

7. CHECK BOX IF REPORT TO COUNCIL IS ATTACHED

8. COMPLETE FOR ACCOUNTING PURPOSES

FUND	DEPT.	ORGANIZATION	OBJECT ACCOUNT	JOB ORDER	C.I.P. NUMBER	AMOUNT	9. ADDITIONAL INFORMATION / ESTIMATED COST:

10. ROUTING AND APPROVALS

ROUTE (#)	APPROVING AUTHORITY	APPROVAL SIGNATURE	DATE SIGNED	ROUTE (#)	APPROVING AUTHORITY	APPROVAL SIGNATURE	DATE SIGNED
1	ORIG. DEPT			8	DEPUTY CHIEF		
2				9	COO		
3				10	CITY ATTORNEY		
4	CFO			11	ORIG. DEPT		
5					DOCKET COORD: _____	COUNCIL LIAISON _____	
6					<input checked="" type="checkbox"/> COUNCIL PRESIDENT	<input type="checkbox"/> SPOB <input type="checkbox"/> CONSENT	<input checked="" type="checkbox"/> ADOPTION
7						<input type="checkbox"/> REFER TO: _____	COUNCIL DATE: 9/04/07

11. PREPARATION OF: RESOLUTIONS ORDINANCE(S) AGREEMENT(S) DEED(S)

Report from the Independent Monitor, Council Discussion and possible Council Action regarding the First Report to the SEC by the San Diego Independent Monitor dated June 7, 2007

11A. STAFF RECOMMENDATIONS:

12. SPECIAL CONDITIONS (REFER TO A.R. 3.20 FOR INFORMATION ON COMPLETING THIS SECTION.)

COUNCIL DISTRICT(S):

COMMUNITY AREA(S):

ENVIRONMENTAL IMPACT: THIS ACTION IS NOT A "PROJECT" FOR PURPOSES OF CEQA

HOUSING IMPACT:

OTHER ISSUES: