

#330
5/6/08

**OFFICE OF INDEPENDENT BUDGET ANALYST
CITY OF SAN DIEGO
M E M O R A N D U M**

Date: May 5, 2008
To: Honorable Council President Peters and Members of the City Council
From: Andrea Tevlin, Independent Budget Analyst *AT*
Subject: Item 330: Response to the Report from the Independent Oversight Monitor

At the first hearing of this item on April 1, 2008, the City Council requested Jay Goldstone, COO, to review his initial draft response with our office and revise accordingly. Attached for your information is the strike-out/underline version with the suggested revisions that we provided to Mr. Goldstone on April 9, 2008. The draft prepared for Tuesday's docket incorporates all of our substantive changes.

Attachment

April 1, 2008

Mr. Kelly C. Bowers
Senior Assistant Regional Director
Securities and Exchange Commission
Los Angeles Regional Office
11th Floor
5670 Wilshire Boulevard
Los Angeles, CA 90036-3648

Dear Mr. Bowers:

This is in response to the 36 recommendations contained in the First Annual Report of the Independent Consultant to the City of San Diego dated March 25, 2008 (Report). For many of the recommendations the City and/or the San Diego City Employee Retirement System (SDCERS) have already taken corrective or proactive action to implement.

Financial Control Structure Audit Committee

Recommendation 1:

The City should submit to the voters for approval in June 2008, and timely take all action to meet that schedule, the establishment of an Audit Committee that meets the following criteria:

- *Has the requisite independence from financial management.*
- *Has the requisite expertise to perform its oversight functions.*
- *Has a sufficient relationship with the City Council to engender its confidence in view of the Council's role in the City's financial reporting.*

Response 1:

The City concurs with this recommendation and has approved and placed on the June 2008 ballot for consideration.

Internal Audit Function

Recommendation 2:

The City should submit to the voters for approval in June 2008, and timely take all action to meet that schedule, the creation of an office of City Auditor that is separate from the current office of Auditor and Comptroller and with direct reporting responsibility to the Audit Committee.

Response 2:

The City concurs with this recommendation. The Office of the City Auditor was established by the Mayor and City Council in calendar year 2007 by separating the internal audit functions from the comptroller duties. The reporting structure was also

changed so that the City Auditor no longer reports to the Auditor & Comptroller (Chief Financial Officer) but rather to the Chief Operating Officer.

In addition, the Mayor has signed a Statement of Operating Principles (SOP) that provides for the City Auditor to communicate directly with and be responsive to requests of the Audit Committee. The City Council has appended the SOP to the Audit Committee Charter. Until the Charter is amended, this is the most effective segregation of duties permitted. In addition, the City has approved and will place a Charter amendment on the June 2008 ballot which would, among other things, have the City Auditor report to the Audit Committee.

Deleted: In addition, there is an informal reporting by the City Auditor to the Audit Committee of the City Council.

Recommendation 3:

The City should begin the process of significantly increasing the staffing of the internal audit function in order to permit effective internal auditing to be accomplished, including an assessment by the internal auditor of staffing needs, and should periodically report its progress to the Audit Committee.

Response 3:

The City concurs with this recommendation. As part of the Mayor's fiscal year 2009 recommended budget, staff for the Office of the City Auditor will be increased from the current five full-time equivalent (FTE) to ten FTE's, a 100% increase. This is the first step in a proposed three year plan to bring the staffing levels within the Office to a more reasonable level.

Prior to the development of the Mayor's recommended budget, the Audit Committee engaged a professional audit consultant (Jefferson Wells) to benchmark audit functions of other similar municipalities and determine appropriate staff levels for an organization of our size. They recommended a staffing level of approximately 24 auditors for the City. The City Council will be considering the Mayor's proposal along with the results of the Jefferson Wells study during fiscal year 2009 budget deliberations in April and May 2008. Final budget decisions will be made in June 2008. Attachment 1 is a response prepared by the City Auditor to the Audit Committee in response to a recommendation by Jefferson Wells to bring the staffing level to around 24 FTEs.

Whistleblower and Hotline Complaint System

Recommendation 4:

The City should implement within 45 days, consistent with the advice of Jefferson Wells for steps prior to Charter revision, the procedure contemplated by the Audit Committee charter for a confidential and anonymous hotline involving the Audit Committee independent of City management for complaints and concerns regarding financial control or financial and auditing matters.

Response 4:

The City concurs with this recommendation. In anticipation of the proposed Charter amendment on the June 2008 ballot, steps are being taken to transfer oversight of the hotline to the Office of the City Auditor. The proposed Charter amendment changes

include having the City Auditor report to the Audit Committee and the granting the City Auditor the power to investigate any material claim of financial fraud, waste, or impropriety within any City Department.

The City Council is expected to discuss and address the hotline reporting recommendations from Jefferson Wells on April 28, 2008. In the interim period before proposed Charter reform in June 2008, the City Council will consider adopting a resolution providing that hotline complaints and activity be directly reported to the Audit Committee as recommended by Jefferson Wells. Additionally, the Council will consider requesting the City Auditor to audit the hotline process and related reporting.

Deleted: The City Council is expected to address hotline reporting issues at a City Council in April 2008.

Improper Influence Ordinance

Recommendation 5:

The City should address any remaining issues expeditiously so that an improper influence ordinance can be adopted as promptly as practicable.

Response 5:

The City concurs with this recommendation. A draft ordinance has been circulated to the Council and the Rules Subcommittee. The outstanding issues deal with what entity should enforce the ordinance, the type of enforcement, and the definition of certain terms. Efforts to resolve these issues are continuing and an ordinance will be presented to Council no later than December 2008.

Focused Financial Management Responsibility and Accountability

Recommendation 6:

The City should submit to the voters for approval by June 2008, and timely take all action to meet that schedule, the separation of the Auditor and Comptroller position into two and the creation of the position of Chief Financial Officer in order to focus responsibility and related accountability for the City's financial reporting.

Response 6:

The City concurs with this recommendation and has approved and placed on the June 2008 ballot for consideration.

Internal Controls Remediation

Recommendation 7:

The City needs to better integrate and coordinate its ERP process and ICOFR process in order to align their objectives, maximize utilization of available resources and achieve optimum results. This should be addressed (to the extent it has not been), with identification of defined tasks, specific individuals with responsibility and specific resources to be employed, within 45 days.

Response 7:

The City concurs with this recommendation. Steps have already been taken to address this recommendation and include: consolidating both efforts under the direction of the Chief Financial Officer (CFO) and the Comptroller, tasking the Comptroller's ICOFR team with reviewing ERP system design specifications and process documentation and documenting the "to be" process in accordance with COSO internal control methodology and developing the applicable policies and procedures in order to provide effective employee training. The relation between the City's ICOFR initiative and the ERP initiative were defined in a presentation to the City Council Audit Committee on March 10, 2008.

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Recommendation 8:

The City needs to devote additional resources to the ICOFR process if the internal control remediation activities are to be completed within a reasonable time frame. The City should consider hiring an outside consulting firm with experience in developing, implementing and remediating an internal control structure within a governmental entity. These efforts should be assessed quarterly to determine if adequate progress is being made.

Response 8:

The City concurs with the spirit of this recommendation. In this regard, the City's proposed fiscal year 2009 budget provides for two additional staff members for the Comptroller's ICOFR team. If adopted by the City Council, this would bring the total budgeted labor allocation for the project to 6240 hours which reflects an approximate 25% greater commitment to the project than required by initial estimates. Additionally, temporary resources will be provided to the project on as needed basis to ensure that project needs are met.

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Management does not agree with "outsourcing" the development and documentation of internal controls. It is important to note, that while the documentation and assessment of internal controls is frequently conducted by consultants in the private sector, the recommendation runs counter in spirit to Kroll Recommendation 53 which states: "The City should assign the responsibilities for preparing public documents and filings to the appropriate City employees. Ultimate responsibility for preparing these City documents cannot be assigned to the independent auditor, disclosure counsel, fiduciary counsel, actuary, or other professionals."

Accordingly, because internal controls are based on the objectives set by management and are the processes that are used to construct public documents and filings, management believes that the recommendation is inconsistent with that of the Report of the Audit Committee. Additionally, management believes that employee ownership of internal control design and documentation is critical to the success of continued monitoring and improvement of the City's internal control framework over time.

Recommendation 9:

The City should establish a reasonable schedule and budget for developing and implementing installation of the ERP system that takes into account integration of the ICOFR process. This should be done within 60 days.

Response 9:

The City concurs with this recommendation and is currently reviewing the timeline for developing and implementing both projects. The results of this review are planned to be presented to the City Council Rules Committee on April 23, 2008.

Recommendation 10:

The City should continue to take a top-down, risk-based approach to remediating its internal control weaknesses as a more effective way to timely identify critical internal control processes, and should address the deficiencies and weaknesses identified in the Kroll Report, the Yellow Book reports and the Auditor and Comptroller annual reports, but should go beyond these to look at internal controls on a comprehensive basis. These efforts should be assessed quarterly.

Response 10:

The City concurs with this recommendation and plans to brief the City Council on these efforts quarterly. Additionally, upon completion of the ICOFR process, management plans to extend its internal control review beyond Reporting and to other elements of the COSO framework including Operational, Compliance and Strategic control objectives and processes.

Recommendation 11:

In assessing significant accounts and underlying processes as part of the ICOFR process, the City needs to look below the top-level government-wide financial statements to the individual financial statements that comprise the CAFR. This should be done within 60 days.

Response 11:

The City concurs with this process and will supplement its quantitative assessment through the use of a qualitative process to identify controls related to unique or significant activities which may impact operating results at the fund level in the City's Financial Statements.

Recommendation 12:

The City should consider interim remediation options to enhance confidence in the reliability of financial reporting in the near term, including development of period-end financial reporting routines. The City also should prioritize its remediation efforts to address the most critical needs as promptly as possible. It should report to the Audit Committee on the progress of these efforts at least quarterly.

Response 12:

The City concurs with this recommendation. The City has predefined period-end financial reporting routines; however, they are not documented. Staff plans to present formal documentation of the City's existing period-end financial reporting routines to the Audit Committee no later than May 2008. These processes will reflect the City's current "as is" routine for compiling monthly and fiscal year end financial reports. With the implementation of the ERP system, the City will be moving toward calendar based reporting periods rather than periods based on the City's payroll cycle. As such, the ICOFR process in connection with the implementation of the ERP system will produce completely revised financial reporting routines. These routines will be documented prior to "go live" on the new accounting system.

Financial Reporting Enhancements
Review of CAFRS

Recommendation 13:

The Audit Committee, with the assistance of its ad hoc advisory group and its professional consultant, should review within 45 days and improve as necessary its procedures for review of the City's CAFR to determine if any improvements should be made to those procedures.

Response 13:

The City concurs with this recommendation. The City has now completed four CAFRs, with three of them being reviewed by the Audit Committee. The Audit Committee began reviewing the City's fiscal year 2006 CAFR on April 4th and will resume its review on April 14th. Following the review of this CAFR, the Audit Committee will docket a discussion with management and outside disclosure counsel to discuss what has worked and perhaps what improvements could be made to the CAFR review process.

Deleted: The Audit Committee will begin reviewing the City's fiscal year 2006 CAFR in early April.

The Audit Committee appointed an ad hoc advisory group in 2007 to analyze the City's CAFR review process and make recommendations for improvement. Additionally, the Audit Committee similarly requested that Jefferson Wells examine the City's CAFR review process. It is expected that reports from the ad hoc advisory committee and Jefferson Wells will be presented to the Audit Committee on April 28th.

Shelf-Like Disclosure System

Recommendation 14:

The City, with the assistance of the DPWG, should evaluate within 6 months the desirability of a shelf-like disclosure system to improve the quality and timeliness of its reporting to the financial markets on an ongoing basis and to permit the efficient access to the capital markets for needed financing.

Response 14:

The DPWG procedures for review of Official Statements are designed to ensure, to the extent possible, that such Statements contain no material misstatements or omissions and otherwise are consistent with disclosure best practices. The procedures require multiple levels of review, including by a "Financing Group" and the full Disclosure Practices Working Group. The Financing Group is appointed for each transaction, and consists of the Deputy City Attorney for Finance and Disclosure, outside disclosure counsel, and the bond financing team (bond counsel, underwriter, underwriter's counsel, financial advisors, City staff - i.e., those persons generally thought of as the core working group). An Official Statement will be prepared by the bond financing team, reviewed by the Financing Group and the Disclosure Practices Working Group, certified as to its accuracy by the Mayor and the City Attorney, and by the City Auditor as to the financial statements and any abstracts from such statements in the body of the Official Statement.

Such multiple levels of review require a considerable amount of time. There are various alternatives to address this that the City has under consideration. One approach would be to move towards "shelf-like" disclosure. This has been used by municipal issuers, which prepare, for example, annual information statements, quarterly updates to those statements, and a separate bring-down supplement for each financing. This would ensure that at any point in time the City's disclosure was relatively recent and would avoid any delays as the City tries to come to market.

An alternative approach would be for the City's financial staff to carefully monitor the calendar for upcoming financings, and be sure to allow sufficient lead time to accommodate the DPWG review procedures. This is the approach that is, in effect, being utilized today. The DPWG established and published timelines for review of both Official Statements and other disclosure documents. City staff is responsible for monitoring the forward financing calendar with such timelines in mind.

The shelf-like registration would require the City to at all times have a relatively current disclosure document. Whether such approach or the current approach of monitoring carefully the forward calendar is the most efficacious will depend in principal part on the frequency of the City's financings. If the City were to plan on entering the market for City-backed debt, whether general fund secured, water or wastewater revenue secured, or otherwise, on, for example, a quarterly or more frequent basis, the shelf-like review may be preferable. On the other hand, if the City were only entering the market once or twice a year, the constant review and updating necessitated by the shelf-like process may not be efficient.

The City will carefully consider these factors and work closely with the Independent Consultant, the Deputy City Attorney for Finance and Disclosure, and the City's outside disclosure counsel, to arrive at the optimal approach for the City in light of the considerations outlined above.

Recommendation 15:

The City, with the assistance of the DPWG, should, in connection with planning to reenter the public market, evaluate the relation of the CAFR to the offering disclosure document and, in particular, should consider no later than in connection with the 2007 CAFR the role and coverage of the Letter of Transmittal in relation to the CAFR with a view to eliminating unnecessary repetition and discussion.

Response 15:

The City concurs with this recommendation. In this regard management will present to the DPWG (a working group composed of City employees) for fiscal year 2007 a significantly revised letter of transmittal which conforms to the consultants' other recommendations and is in keeping with best practices for financial reporting. The DPWG will consider whether certain information in the letter of transmittal should more appropriately be included in any official statement provided to investors.

Improved Discussion and Analysis

Recommendation 16:

The City, no later than in connection with its 2007 CAFR, should improve the quality of its financial disclosure by providing an analysis, either in the MD&A or Letter of Transmittal, as appropriate, that facilitates an understanding of the City's financial statements and its financial condition, financial results, liquidity and capital needs, including the risks faced by the City.

Response 16:

Financial Management notes that the recommendation reflects the existing function of both the Letter of Transmittal and Management's Discussion and Analysis and that they are both prepared in accordance with accepted guidance promulgated by the Governmental Accounting Standards Board and Government Finance Officers Association. Management agrees, however, that governmental accounting is a complex topic and that improvements can be made in the context of the SEC's Plain English initiatives. Accordingly, financial management will revise the Letter of Transmittal and Management's Discussion and Analysis in an effort to deemphasize certain topics and better communicate the issues raised in this recommendation.

Disclosure of Contractual and Off-Balance Sheet Obligations

Recommendation 17:

The City, beginning with the 2007 CAFR, should include in either the Letter of Transmittal or MD&A, a tabular presentation of its contractual and off-balance sheet obligations and other commitments shown by relevant time periods and with totals.

Response 17:

Financial Management notes that in accordance with Governmental Accounting Standards Board Statements, the City's debt service (principal and interest) obligations, capital and operating lease obligations, pension and post-retirement benefit obligations, purchase commitments and other contractual obligations, and other long-term liabilities shown on the statement of net assets are currently discussed in detail in notes 5, 6, 10, 12, 17 and 18 to the financial statements in recently released CAFRS. For items not yet required to be disclosed in the Notes (OPEB), the City has voluntarily disclosed that liability in its Letter of Transmittal.

Loss Contingencies and Risk Assessments

Recommendation 18:

The City, through the City Attorney Office, should, prior to the preparation of the 2007 CAFR, improve its systems for dealing with loss contingencies for financial reporting purposes in order to remedy any deficiencies raised not by the City's independent auditors to the extent not already remedied.

Response 18:

Financial Management agrees with this finding; however, notes that the City Attorney is an independently elected official and that the valuation of contingent liabilities is almost fully under the purview and expertise of the City Attorney. As a supplemental recommendation, financial management recommends that the City Attorney should immediately publish procedures for work product review by supervising attorney's and also publish procedures concerning the compilation of the FASB 5 letter from the City Attorney. This would put in place revised internal controls that would demonstrate that the FASB 5 response of the City Attorney not only reflects what is in the City Attorney's case files but that the case files themselves are maintained in accordance with attorney work product standards. Once these procedures are in place, the City Attorney could request a review by the City's Internal Auditor to ensure they are operating effectively. Additionally, this would strengthen already established procedures for communicating the status of contingent liabilities to the City's director of risk management.

Disclosure Practices Working Group (DPWG)

Recommendation 19:

City officials should, to the extent they have not done so, appoint designees to the DPWG within 30 days to ensure availability of quorums and continuity from meeting to meeting.

Response 19:

The City concurs with this recommendation and will request permanent appointees designate alternates to the DPWG to formally substitute representatives to the DPWG to ensure that there will be a quorum at all scheduled DPWG meetings. In addition, steps will be taken to assure that permanent appointees and their substitutes stay abreast of the principal disclosure matters being addressed by DPWG from time to time to ensure the quality of the disclosure.

Recommendation 20:

The DPWG should continue to establish a regular meeting schedule.

Response 20:

The City concurs with this recommendation and the DPWG has already established a set meeting schedule. The DPWG meets the 1st and 3rd Wednesday of every month and more frequently as necessary.

Recommendation 21:

Any necessary changes to the Disclosure Controls and Procedures to reflect changes to the Municipal Code should be effected within 45 days.

Response 21:

The City concurs with this recommendation. A draft of a revised Disclosure Controls and Procedures to conform to the Municipal Code and to make other appropriate changes has been circulated and will be adopted within the recommended timeframe.

Recommendation 22:

The DPWG should assess the effectiveness of its review of the form and content of "press releases, ... web-site postings, and other communications reasonably likely to reach investors or the securities markets" as set forth in Section 22.4107(a)(1) of the Municipal Code and within 45 days recommend changes, if any, to reflect actual practices within the City.

Response 22:

The DPWG has discussed on several occasions the impracticality of reviewing and commenting on press releases, web-site postings and other communications. In recognition of this, it has been suggested and consistent with Recommendation 23, below, the Management is establishing an Investor Information web page on which City financial information that has been reviewed and signed off by the DPWG will be posted. The DPWG will review Section 22.4107(a)(1) of the Municipal Code and will recommend changes as appropriate.

Recommendation 23:

In connection with the foregoing, the City should revise its website within 90 days to have a dedicated portal where official documents reviewed by the DPWG can be posted.

Response 23:

The City concurs with this recommendation. The City's Investor Information webpage shall provide a portal in which official statements for outstanding bond issuances will be archived. In addition, official statements for new bond offerings, which have been reviewed by DPWG, shall also be posted on the webpage. This site will also maintain all material event notices and the continuing disclosure annual reports disseminated to the market. A prototype of the Investor Information webpage, created with the City disclosure counsel's assistance, is scheduled to be reviewed by the DPWG on April 2, 2008, and the webpage is anticipated to go live by mid-April, 2008. The City staff will administer ongoing updates to the website in consultation with the DPWG.

Recommendation 24:

The DPWG should, as required by the Municipal Code, continue to assess at least annually the adequacy of its existing processes and propose modifications to enhance the efficiency and overall effectiveness of its operations.

Response 24:

The City concurs with this recommendation and the DPWG will at least annually assess the adequacy of its existing processes and propose modifications to enhance the

efficiency and overall effectiveness of its operations. This review will be especially critical as the City prepares to re-enter the public bond markets for the first time since the DPWG was established. The DPWG has conducted such internal reviews on an annual basis, and the third annual report was released on December 15, 2007.

Recommendation 25:

The DPWG, in conjunction with City financial management and the IBA, should assess the current training program for City officials and staff and recommend and implement changes, if any, within 45 days.

Response 25:

The City concurs with this recommendation. A panel including representatives from the DPWG, the IBA, and financial management will review the current training program and make recommendations regarding the current training program for city officials and staff and make recommendations and implement changes, if any, within 45 days.

Role of Counsel in Legal Compliance

Recommendation 26:

The City should consider whether any steps are necessary to ensure the availability of legal counsel that will foster the ability of City officials to consult with and obtain legal advice based upon a relationship of trust and confidence designed to promote legal compliance.

Response 26:

The City concurs with this recommendation. There is some disagreement among City officials on the role of the City Attorney. The City Attorney as a city-wide elected official, currently views his client as the public rather than the City and its officials. As such, the City Attorney on occasion pursues policy and/or legal positions that are contrary to the legal/policy positions adopted by the Council and/or the Mayor. The City Attorney also believes that he can initiate civil proceedings without authorization by the City Council. A committee that reviewed the City Charter recommended that changes be made to the Charter to better clarify that the role of the City Attorney, whether elected or not, is to represent the City and its officials and that litigation can only be initiated with Council approval. Those recommendations were not included in ballot measures coming before the citizens in June 2008. Nonetheless, City officials work to promote procedures that foster compliance with disclosure and all other legal requirements, including work on the DPWG, the completion of 4 CAFRs, cooperation with the SEC independent monitor, and implementation with Kroll recommendations. The issues of authorization and identity of the client may require judicial resolution.

San Diego City Employees Retirement System (SDCERS)

Recommendation 27:

The City Council should address within 30 days the "technical corrections ordinances and the "waterfall" ordinance. It also should act on the matters required by the compliance statement with the IRS within the time specified therein.

Response 27:

City concurs with this recommendation. Docketed for the April 1, 2008 City Council meeting is the first reading of an Ordinance to implement the Settlement Agreement between SDCERS, The City of San Diego and the Internal Revenue Service. In addition, SDCERS and City Management have been attempting to modify the Municipal Code to "officially" eliminate the use of "surplus earnings" to pay for certain retirement benefits. The actual use of "surplus earnings" ended with the City's June 30, 2006 actuarial valuation. At that time, SDCERS directed its actuary to include the payment of the 13th check and Corbett Benefits in its valuation liabilities and as a result these two benefits are now being paid for by the City as part of its Annual Required Contribution. As such, no benefits are being paid from "surplus earnings." Several attempts to bring the Municipal Code into conformity with this practice have not been successful and staff will continue to attempt to bring this matter forward for City Council action.

For additional information, please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 28:

To the extent necessary, SDCERS should be asked to adopt promptly any necessary amendments to its other "controlling documents," following final action by the City Council regarding the matters listed in the preceding recommendation.

Response 28:

Please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego March 27, 2008 (**Attachment 2**).

Recommendation 29:

The Mayor should make reasonable efforts to appoint or reappoint trustee to fill the current vacant and holdover positions on the SDCERS Board within 90 days.

Response 29:

The City concurs with this recommendation. The Mayor has appointed several new members to the SDCERS Board and regularly searches and solicits qualified individuals to fill vacancies on the Board. Recently, the SDCERS Board purchased Directors and Officers insurance, which should assist in process of filling positions because there are

concerns about lawsuits being initiated against the directors. Because of the importance of the position and the extensive qualifications necessary, the appointment process is necessarily slower than desired.

For additional information, please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 30:

SDCERS should continue to develop and implement a comprehensive training program for its trustees and staff, including training in pension, finance and investing and in prudent trustee requirements. It should report quarterly on these training activities.

Response 30:

Please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 31:

SDCERS, in conjunction with the City management, should evaluate the communication process and information flow between SDCERS and the City and adopt necessary modifications, if any, to this process to ensure the complete and timely flow of pension and benefit-related information to the City necessary for fiscal planning and the preparation of the City's financial statements.

Response 31:

Financial Management concurs with this recommendation and notes that several mitigating procedures have already been put in place. These procedures include monthly meetings between the SDCERS CFO and the City Comptroller and a mutual review of each entity's CAFR prior to issuance. Additionally, the two organizations regularly communicate as necessary concerning issues of mutual interest. Management recognizes, however, that effective communication is sometimes hampered by ongoing litigation between the two entities.

For additional information, please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 32:

SDCERS should report quarterly on the actions taken to remediate its failures to comply with applicable legal requirements and to ensure that similar failures do not reoccur.

Response 32:

Please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 33:

The City, working with SDCERS and with the assistance of an experienced pension consultant, should explore the range of alternatives for funding the City's pension and post-retirement benefits commitments. Alternatives might include, for example, funding alternatives, reduction or freezing of benefits, or establishing, as some private entities have done, a separate employee/union controlled plan that relieves the employer of further obligations. While all such alternatives are subject to legal, contractual and employee relation considerations, a comprehensive report should be issued by December 31, 2008.

Response 33:

The City concurs in this recommendation. The City has taken significant steps to reduce its pension obligations and its post-retirement benefits commitments. The City is funding not only its full pension yearly obligations but also paying in excess of its obligations. The City is also proposing a new pension system for new employees that reduces City obligations significantly. Based upon court decisions, reduction of obligations for existing employees has not been possible. The City has also reduced post-retirement commitments. By agreement effective July 2005, the City eliminated retiree health benefits. The City has also taken steps to fund its current health benefits by establishing a trust that with CalPERS and has deposited approximately \$30 million into this account during fiscal year 2008.

For additional information, please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 34:

SDCERS' plan actuary should perform an experience study to assess the correctness of the actuarial assumption being used as promptly as practical but within 120 days. This and future experience studies, as well as future actuarial reports, should reflect the effect of the DROP program.

Response 34:

Please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Training

Recommendation 35:

The City, with the involvement of the DPWG and the IBA, as applicable, should develop within 90 days a comprehensive and coordinated training program for City officials and personnel on disclosure and financial reporting and then should report quarterly on the implementation and effectiveness of that program and any changes made to it.

Response 35:

The City concurs with this recommendation. In December 2006, the City Council adopted a comprehensive financial training program developed by the Office of the Independent Budget Analyst (IBA) at their request. Trainings to date covering disclosure (March 2007) and financial reporting (April 2007) have effectively been coordinated with certain members of the DPWG and City fiscal/legal consultants. The City Council training program is: comprehensive for elected official needs/purposes; systematic in requiring that certain important financial topics be covered once every two years; and available to City staff/public live and via 7/24 replay on the City's website.

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A panel including representatives from the DPWG, the IBA, and financial management will review the current training programs for the City Council and City staff. The panel will make recommendations regarding the current training programs and implement changes, if any, within 45 days.

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Fiscal Integrity

Recommendation 36:

The City should assess the value of its current Five-Year Financial Outlook as a planning tool, and consider use of additional planning tools, for ensuring that the City is able to meet its goals for providing services to the citizens of San Diego at a cost they are willing to bear.

Response 36:

The City's Five Year Financial Outlook (Outlook) provides the framework for informed budgetary planning and the adoption of the City's annual budget. The City currently works with state and regional agencies to incorporate relevant economic research and policy trends to inform the City's forecast. The City incorporates this research and continual in-house analysis in periodic updates to the Outlook throughout the year as economic conditions and demands on city resources change to keep the forecast relevant to current conditions. The City continues to evaluate best practices for long term fiscal planning and intends to implement any enhancements that can be realistically supported by available resources.

Additionally, IBA Report #08-9 noted items that were not considered in the Outlook that are likely to impact the City's General Fund. The IBA Report also compared the City's Outlook to other municipal forecasts and suggested common features that could add value in future updates (i.e., a discussion of risks). City management has reviewed the IBA's recommendations and indicated that they will incorporate them into the next Outlook.

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The City will continue to work with the Independent Consultant to not only implement these recommendations but also to go beyond in order to ensure that the City continues to establish best practices in its financial reporting and ultimate disclosure.

Sincerely,

JERRY SANDERS
Mayor

SCOTT PETERS
City Council President

Attachments

Cc: Honorable Members of City Council/Audit Committee Members
Michael Aguirre, City Attorney
Stanley Keller, Independent Consultant
Jay M. Goldstone, Chief Operating Officer
Andrea Tevlin, Independent Budget Analyst

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10:13 AM

May 6, 2008

Mr. Kelly C. Bowers
Senior Assistant Regional Director
Securities and Exchange Commission
Los Angeles Regional Office
11th Floor
5670 Wilshire Boulevard
Los Angeles, CA 90036-3648

Dear Mr. Bowers:

This is in response to the 36 recommendations contained in the First Annual Report of the Independent Consultant to the City of San Diego dated March 25, 2008 (Report). For many of the recommendations the City and/or the San Diego City Employee Retirement System (SDCERS) have already taken corrective or proactive action to implement.

Financial Control Structure Audit Committee

Recommendation 1:

The City should submit to the voters for approval in June 2008, and timely take all action to meet that schedule, the establishment of an Audit Committee that meets the following criteria:

- *Has the requisite independence from financial management.*
- *Has the requisite expertise to perform its oversight functions.*
- *Has a sufficient relationship with the City Council to engender its confidence in view of the Council's role in the City's financial reporting.*

Response 1:

The City concurs with this recommendation and has approved and placed on the June 2008 ballot for consideration. The Independent Consultant, in his capacity as monitor, has reviewed and approved the language contained in the ballot proposal.

Internal Audit Function

Recommendation 2:

The City should submit to the voters for approval in June 2008, and timely take all action to meet that schedule, the creation of an office of City Auditor that is separate from the current office of Auditor and Comptroller and with direct reporting responsibility to the Audit Committee.

Response 2:

The City concurs with this recommendation. The Office of the City Auditor was established by the Mayor in calendar year 2007 by separating the internal audit functions from the comptroller duties. The reporting structure was also changed so that the City Auditor no longer reports to the Auditor & Comptroller (Chief Financial Officer) but rather to the Chief Operating Officer. Given certain restrictions in the City's Charter which limits a further separate duties, this organizational change separates the Department and reporting structure of those responsible for preparing the City's financial information and establishing the City's internal controls from those responsible to oversee and report on the adequacy of these controls.

In addition, the Mayor has signed a Statement of Operating Principles (SOP) that provides that the City Auditor to communicate directly with and be responsive to requests from the Audit Committee. The City Council has attached the SOP to the Audit Committee Charter. Until the Charter is amended, this is the most effective segregation of duties permitted. In addition, the City has approved and will place a Charter amendment on the June 2008 ballot which would, among other things, have the City Auditor report to the Audit Committee.

Recommendation 3:

The City should begin the process of significantly increasing the staffing of the internal audit function in order to permit effective internal auditing to be accomplished, including an assessment by the internal auditor of staffing needs, and should periodically report its progress to the Audit Committee.

Response 3:

The City concurs with this recommendation. The Audit Committee engaged a professional consultant (Jefferson Wells) to benchmark audit functions of other similar municipalities and determine appropriate staff levels for an organization of this City's size. They recommended a staffing level of approximately 24 auditors for the City.

As part of the Mayor's fiscal year 2009 recommended budget, staff for the Office of the City Auditor will be increased from the current five full-time equivalent (FTE) to ten FTE's, a 100% increase. This is the first step in a multi-year plan to bring the staffing levels within the Office to a more reasonable level. The City Council will be considering the Mayor's proposal along with the results of the Jefferson Wells study during fiscal year 2009 budget deliberations in April and May 2008. Final budget decisions will be made in June 2008. **Attachment 1** is a response prepared by the City Auditor to the Audit Committee in response to a recommendation by Jefferson Wells to bring the staffing level to around 24 FTEs.

Whistleblower and Hotline Complaint System

Recommendation 4:

The City should implement within 45 days, consistent with the advice of Jefferson Wells for steps prior to Charter revision, the procedure contemplated by the Audit Committee charter for a confidential and anonymous hotline involving the Audit Committee

independent of City management for complaints and concerns regarding financial control or financial and auditing matters.

Response 4:

The City concurs with this recommendation. In anticipation of the proposed Charter amendment on the June 2008 ballot, steps are being taken to transfer oversight of the hotline to the Office of the City Auditor. The proposed Charter amendment changes include having the City Auditor report to the Audit Committee and the granting the City Auditor the power to investigate any material claim of financial fraud, waste, or impropriety within any City Department.

The City Council is expected to discuss and address the hotline reporting recommendations on April 28, 2008. In the interim period before proposed Charter reform in June 2008, the City Council will consider adopting a resolution providing that hotline complaints and activity be directly reported to the Audit Committee. Additionally, the Council will consider requesting the City Auditor to audit the hotline process and related reporting.

Improper Influence Ordinance

Recommendation 5:

The City should address any remaining issues expeditiously so that an improper influence ordinance can be adopted as promptly as practicable.

Response 5:

The City concurs with this recommendation. A draft ordinance was circulated to the Council and the Rules Subcommittee. The outstanding issues deal with what entity should enforce the ordinance, the type of enforcement, and the definition of certain terms. Efforts to resolve these issues are continuing and an ordinance will be presented to Council no later than December 2008.

Focused Financial Management Responsibility and Accountability

Recommendation 6:

The City should submit to the voters for approval by June 2008, and timely take all action to meet that schedule, the separation of the Auditor and Comptroller position into two and the creation of the position of Chief Financial Officer in order to focus responsibility and related accountability for the City's financial reporting.

Response 6:

The City concurs with this recommendation and has approved and placed on the June 2008 ballot for consideration. The Independent Consultant, in his capacity as monitor, has reviewed and approved the language contained in the ballot proposal.

Internal Controls Remediation

Recommendation 7:

The City needs to better integrate and coordinate its ERP process and ICOFR process in order to align their objectives, maximize utilization of available resources and achieve optimum results. This should be addressed (to the extent it has not been), with identification of defined tasks, specific individuals with responsibility and specific resources to be employed, within 45 days.

Response 7:

The City concurs with this recommendation. Steps have already been taken to address this recommendation and include: consolidating both efforts under the direction of the Chief Financial Officer (CFO) and the Comptroller, tasking the Comptroller's ICOFR team with reviewing ERP system design specifications and process documentation and documenting the "to be" process in accordance with COSO internal control methodology and developing the applicable policies and procedures in order to provide effective employee training. The relation between the City's ICOFR initiative and the ERP initiative were defined in a presentation to the City Council Audit Committee on March 10, 2008.

Recommendation 8:

The City needs to devote additional resources to the ICOFR process if the internal control remediation activities are to be completed within a reasonable time frame. The City should consider hiring an outside consulting firm with experience in developing, implementing and remediating an internal control structure within a governmental entity. These efforts should be assessed quarterly to determine if adequate progress is being made.

Response 8:

The City concurs with the spirit of this recommendation. In this regard, the City's proposed fiscal year 2009 budget provides for two additional staff members for the Comptroller's ICOFR team. If adopted by the City Council, this would bring the total budgeted labor allocation for the project to 6240 hours which reflects an approximate 25% greater commitment to the project than required by initial estimates. Additionally, temporary resources will be provided to the project on as needed basis to ensure that project needs are met.

While management does not agree with "outsourcing" the development and documentation of internal controls, there may be situations whereby the retention of a firm with expertise in a particular area may be of benefit to the City.

Recommendation 9:

The City should establish a reasonable schedule and budget for developing and implementing installation of the ERP system that takes into account integration of the ICOFR process. This should be done within 60 days.

Response 9:

The City concurs with this recommendation and is currently reviewing the timeline for developing and implementing both projects. The results of this review are planned to be presented to the City Council Rules Committee on April 23, 2008.

Recommendation 10:

The City should continue to take a top-down, risk-based approach to remediating its internal control weaknesses as a more effective way to timely identify critical internal control processes, and should address the deficiencies and weaknesses identified in the Kroll Report, the Yellow Book reports and the Auditor and Comptroller annual reports, but should go beyond these to look at internal controls on a comprehensive basis. These efforts should be assessed quarterly.

Response 10:

The City concurs with this recommendation and plans to brief the City Council on these efforts quarterly. The next quarterly briefing is planned for late April or early May 2008. Additionally, upon completion of the ICOFR process, management plans to extend its internal control review beyond Reporting and to other elements of the COSO framework including Operational, Compliance and Strategic control objectives and processes.

Recommendation 11:

In assessing significant accounts and underlying processes as part of the ICOFR process, the City needs to look below the top-level, government-wide financial statements to the individual financial statements that comprise the CAFR. This should be done within 60 days.

Response 11:

The City concurs with this process and will supplement its quantitative assessment through the use of a qualitative process to identify controls related to unique or significant activities which may impact operating results at the fund level in the City's Financial Statements.

Recommendation 12:

The City should consider interim remediation options to enhance confidence in the reliability of financial reporting in the near term, including development of period-end financial reporting routines. The City also should prioritize its remediation efforts to address the most critical needs as promptly as possible. It should report to the Audit Committee on the progress of these efforts at least quarterly.

Response 12:

The City concurs with this recommendation. The City has predefined period-end financial reporting routines; however, they are not documented. Staff plans to present formal documentation of the City's existing period-end financial reporting routines to the Audit Committee no later than May 2008. These processes will reflect the City's current "as is" routine for compiling monthly and fiscal year end financial reports. With the

implementation of the ERP system, the City will be moving toward calendar based reporting periods rather than periods based on the City's payroll cycle. As such, the ICOFR process in connection with the implementation of the ERP system will produce completely revised financial reporting routines. These routines will be documented prior to "go live" on the new accounting system.

Financial Reporting Enhancements Review of CAFRS

Recommendation 13:

The Audit Committee, with the assistance of its ad hoc advisory group and its professional consultant, should review within 45 days and improve as necessary its procedures for review of the City's CAFR to determine if any improvements should be made to those procedures.

Response 13:

The City concurs with this recommendation. The City has now completed four CAFRs, with three of them being reviewed by the Audit Committee. The Audit Committee began reviewing the City's fiscal year 2006 CAFR on April 4 and concluded its review on April 18. The City Council reviewed the CAFR on April 22 and voted to receive and file the CAFR. The Audit Committee will docket a discussion with management and outside disclosure counsel to discuss what has worked and perhaps what improvements could be made to the CAFR review process.

The Audit Committee appointed an ad hoc advisory group in 2007 to analyze the City's CAFR review process and make recommendations for improvement and on April 28, 2008 the Ad Hoc Advisory Committee presented its recommendations to the Audit Committee. Additionally, the Audit Committee similarly requested that Jefferson Wells examine the City's CAFR review process and this report was also delivered to the Audit Committee on April 28, 2008.

Shelf-Like Disclosure System

Recommendation 14:

The City, with the assistance of the DPWG, should evaluate within 6 months the desirability of a shelf-like disclosure system to improve the quality and timeliness of its reporting to the financial markets on an ongoing basis and to permit the efficient access to the capital markets for needed financing.

Response 14:

The DPWG procedures for review of Official Statements are designed to ensure, to the extent possible, that such Statements contain no material misstatements or omissions and otherwise are consistent with disclosure best practices. The procedures require multiple levels of review, including by a "Financing Group" and the full Disclosure Practices Working Group. The Financing Group is appointed for each transaction, and consists of the Deputy City Attorney for Finance and Disclosure, outside disclosure

counsel, and the bond financing team (bond counsel, underwriter, underwriter's counsel, financial advisors, City staff - i.e., those persons generally thought of as the core working group). An Official Statement will be prepared by the bond financing team, reviewed by the Financing Group and the Disclosure Practices Working Group, certified as to its accuracy by the Mayor and the City Attorney, and by the City Auditor as to the financial statements and any abstracts from such statements in the body of the Official Statement.

Such multiple levels of review involve significant commitment of time and City resources. There are various alternatives to address this that the City has under consideration. One approach would be to move towards "shelf-like" disclosure. This has been used by municipal issuers, which prepare, for example, annual information statements, quarterly updates to those statements, and a separate bring-down supplement for each financing. This would ensure that at any point in time the City's disclosure was relatively recent and would avoid delays accessing the public capital markets.

An alternative approach would be for the City's financial staff to carefully monitor the calendar for upcoming financings, and be sure to allow sufficient lead time to accommodate the DPWG review procedures. This is the approach that is, in effect, being utilized today. The DPWG established and published timelines for review of both Official Statements and other disclosure documents. City staff is responsible for monitoring the forward financing calendar with such timelines in mind.

The shelf-like registration would require the City to at all times have a relatively current disclosure document. Whether such approach or the current approach of monitoring carefully the forward calendar is the most efficacious will depend in principal part on the frequency of the City's financings. If the City were to plan on entering the market for City-backed debt, whether general fund secured, water or wastewater revenue secured, or otherwise, on, for example, a quarterly or more frequent basis, the shelf-like review may be preferable. On the other hand, if the City were only entering the market once or twice a year, the constant review and updating necessitated by the shelf-like process may not be efficient.

A presentation on a shelf-like registration will be made to the DPWG by the Independent Consultant by the end of April 2008.

The City will carefully consider these factors and work closely with the Independent Consultant, the Deputy City Attorney for Finance and Disclosure, and the City's outside disclosure counsel, to arrive at the optimal approach for the City in light of the considerations outlined above.

Recommendation 15:

The City, with the assistance of the DPWG, should, in connection with planning to reenter the public market, evaluate the relation of the CAFR to the offering disclosure document and, in particular, should consider no later than in connection with the 2007 CAFR the role and coverage of the Letter of Transmittal in relation to the CAFR with a view to eliminating unnecessary repetition and discussion.

Response 15:

The City concurs with this recommendation. In this regard management will present to the DPWG (a working group composed of City employees) for fiscal year 2007 a significantly revised letter of transmittal which conforms to the consultants' other recommendations and is in keeping with best practices for financial reporting. The DPWG will consider whether certain information in the letter of transmittal should more appropriately be included in any official statement provided to investors.

Improved Discussion and Analysis

Recommendation 16:

The City, no later than in connection with its 2007 CAFR, should improve the quality of its financial disclosure by providing an analysis, either in the MD&A or Letter of Transmittal, as appropriate, that facilitates an understanding of the City's financial statements and its financial condition, financial results, liquidity and capital needs, including the risks faced by the City.

Response 16:

Financial Management notes that the recommendation reflects the existing function of both the Letter of Transmittal and Management's Discussion and Analysis and that they are both prepared in accordance with accepted guidance promulgated by the Governmental Accounting Standards Board and Government Finance Officers Association. Management agrees, however, that governmental accounting is a complex topic and that improvements can be made in the context of the SEC's Plain English initiatives. Accordingly, financial management will revise the Letter of Transmittal and Management's Discussion and Analysis in an effort to deemphasize certain topics and better communicate the issues raised in this recommendation.

Disclosure of Contractual and Off-Balance Sheet Obligations

Recommendation 17:

The City, beginning with the 2007 CAFR, should include in either the Letter of Transmittal or MD&A, a tabular presentation of its contractual and off-balance sheet obligations and other commitments shown by relevant periods and with totals.

Response 17:

Financial Management notes that in accordance with Governmental Accounting Standards Board Statements, the City's debt service (principal and interest) obligations, capital and operating lease obligations, pension and post-retirement benefit obligations, purchase commitments and other contractual obligations, and other long-term liabilities shown on the statement of net assets are currently discussed in detail in notes 5, 6, 10, 12, 17 and 18 to the financial statements in recently released CAFRS. For items not yet required to be disclosed in the Notes (OPEB), the City has voluntarily disclosed that liability in its Letter of Transmittal.

Loss Contingencies and Risk Assessments

Recommendation 18:

The City, through the City Attorney Office, should, prior to the preparation of the 2007 CAFR, improve its systems for dealing with loss contingencies for financial reporting purposes in order to remedy any deficiencies raised by the City's independent auditors to the extent not already remedied.

Response 18:

Financial Management agrees with this finding; however, notes that the City Attorney is an independently elected official and that the valuation of contingent liabilities is almost fully under the purview and expertise of the City Attorney. As a supplemental recommendation, financial management recommends that the City Attorney review and publish procedures for work product review by supervising attorney's and also publish procedures concerning the compilation of the FASB 5 letter from the City Attorney. This would put in place revised internal controls that would demonstrate that the FASB 5 response of the City Attorney not only reflects what is in the City Attorney's case files but that the case files themselves are maintained in accordance with attorney work product standards. Once these procedures are in place, the City Attorney could request a review by the City's Internal Auditor to ensure they are operating effectively. Additionally, this would strengthen already established procedures for communicating the status of contingent liabilities to the City's director of risk management.

Disclosure Practices Working Group (DPWG)

Recommendation 19:

City officials should, to the extent they have not done so, appoint designees to the DPWG within 30 days to ensure availability of quorums and continuity from meeting to meeting.

Response 19:

The City concurs with this recommendation and will request permanent appointees designate alternates to the DPWG to formally substitute representatives to the DPWG to ensure that there will be a quorum at all scheduled DPWG meetings. In addition, steps will be taken to assure that permanent appointees and their substitutes stay abreast of the principal disclosure matters being addressed by DPWG from time to time to ensure the quality of the disclosure.

Recommendation 20:

The DPWG should continue to establish a regular meeting schedule.

Response 20:

The City concurs with this recommendation and the DPWG has already established a set meeting schedule. The DPWG meets the 1st and 3rd Wednesday of every month and more frequently as necessary.

Recommendation 21:

Any necessary changes to the Disclosure Controls and Procedures to reflect changes to the Municipal Code should be effected within 45 days.

Response 21:

The City concurs with this recommendation. A draft of a revised Disclosure Controls and Procedures to conform to the Municipal Code and to make other appropriate changes has been circulated and will be adopted within the recommended timeframe.

Recommendation 22:

The DPWG should assess the effectiveness of its review of the form and content of "press releases, ... web-site postings, and other communications reasonably likely to reach investors or the securities markets" as set forth in Section 22.4107(a)(1) of the Municipal Code and within 45 days recommend changes, if any, to reflect actual practices within the City.

Response 22:

The DPWG has discussed on several occasions the impracticality of reviewing and commenting on press releases, web-site postings and other communications. In recognition of this, it has been suggested and consistent with Recommendation 23, below, the Management is establishing an Investor Information web page on which City financial information that has been reviewed and signed off by the DPWG will be posted. The DPWG will review Section 22.4107(a)(1) of the Municipal Code and will recommend changes as appropriate.

Recommendation 23:

In connection with the foregoing, the City should revise its website within 90 days to have a dedicated portal where official documents reviewed by the DPWG can be posted.

Response 23:

The City concurs with this recommendation. The City's Investor Information webpage shall provide a portal in which official statements for outstanding bond issuances will be archived. In addition, official statements for new bond offerings, which have been reviewed by DPWG, shall also be posted on the webpage. This site will also maintain all

material event notices and the continuing disclosure annual reports disseminated to the market. A prototype of the Investor Information webpage, created with the City disclosure counsel's assistance, was reviewed by the DPWG on April 2, 2008, and the webpage is anticipated to go live by early May, 2008. The City staff will administer ongoing updates to the website in consultation with the DPWG.

Recommendation 24:

The DPWG should, as required by the Municipal Code, continue to assess at least annually the adequacy of its existing processes and propose modifications to enhance the efficiency and overall effectiveness of its operations.

Response 24:

The City concurs with this recommendation and the DPWG will at least annually assess the adequacy of its existing processes and propose modifications to enhance the efficiency and overall effectiveness of its operations. This review will be especially critical as the City prepares to re-enter the public bond markets for the first time since the DPWG was established. The DPWG has conducted such internal reviews on an annual basis, and the third annual report was released on December 15, 2007.

Recommendation 25:

The DPWG, in conjunction with City financial management and the IBA, should assess the current training program for City officials and staff and recommend and implement changes, if any, within 45 days.

Response 25:

The City concurs with this recommendation. A panel including representatives from the DPWG, the IBA, and financial management will review the current training programs and make recommendations regarding the current training programs for city officials and staff and make recommendations and implement changes, if any, within 45 days.

Role of Counsel in Legal Compliance

Recommendation 26:

The City should consider whether any steps are necessary to ensure the availability of legal counsel that will foster the ability of City officials to consult with and obtain legal advice based upon a relationship of trust and confidence designed to promote legal compliance.

Response 26:

The City concurs with this recommendation. There is some disagreement among City officials on the role of the City Attorney. The City Attorney as a city-wide elected official, currently views his client as the public rather than the City and its officials. The City Attorney on occasion pursues policy and/or legal positions that are contrary to the

legal/policy positions adopted by the Council and/or the Mayor. The City Attorney also believes that he can initiate civil proceedings without authorization by the City Council.

As noted by the Independent Consultant, that "because of the potential for tension between separately elected officials there may be a need for legal counsel who is in a position to serve as adviser to other elected officials and thus able to advise on legal compliance as matters are being considered." The City Council has from time-to-time hired outside counsel to advise it and the Mayor on particular issues and has even retained outside legal counsel to represent the City on matters where it has been determined that the City Attorney has taken a position contrary to the best interest of the City.

In addition, a committee that reviewed the City Charter recommended that changes be made to the Charter to better clarify that the role of the City Attorney, whether elected or not, is to represent the City and its officials and that litigation can only be initiated with Council approval. Those recommendations were not included in ballot measures coming before the citizens in June 2008. Nonetheless, City officials work to promote procedures that foster compliance with disclosure and all other legal requirements, including work on the DPWG, the completion of four CAFRs, cooperation with the SEC Independent Consultant, and implementation with Kroll recommendations. The issues of authorization and identity of the client may require judicial resolution.

San Diego City Employees Retirement System (SDCERS)

Recommendation 27:

The City Council should address within 30 days the "technical corrections ordinances and the "waterfall" ordinance. It also should act on the matters required by the compliance statement with the IRS within the time specified therein.

Response 27:

City concurs with this recommendation. Docketed for the April 1, 2008 City Council meeting is the first reading of an Ordinance to implement the Settlement Agreement between SDCERS, The City of San Diego and the Internal Revenue Service. In addition, SDCERS and City Management have been attempting to modify the Municipal Code to "officially" eliminate the use of "surplus earnings" to pay for certain retirement benefits. The actual use of "surplus earnings" ended with the City's June 30, 2006 actuarial valuation. At that time, SDCERS directed its actuary to include the payment of the 13th check and Corbett Benefits in its valuation liabilities and as a result these two benefits are now being paid for by the City as part of its Annual Required Contribution. As such, no benefits are being paid from "surplus earnings." Several attempts to bring the Municipal Code into conformity with this practice have not been successful and staff will continue to attempt to bring this matter forward for City Council action.

For additional information, please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 28:

To the extent necessary, SDCERS should be asked to adopt promptly any necessary amendments to its other "controlling documents," following final action by the City Council regarding the matters listed in the preceding recommendation.

Response 28:

Please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego March 27, 2008 (**Attachment 2**).

Recommendation 29:

The Mayor should make reasonable efforts to appoint or reappoint trustee to fill the current vacant and holdover positions on the SDCERS Board within 90 days.

Response 29:

The City concurs with this recommendation. The Mayor has appointed several new members to the SDCERS Board and regularly searches and solicits qualified individuals to fill vacancies on the Board. Recently, the SDCERS Board purchased Directors and Officers insurance, which should assist in process of filling positions because there are concerns about lawsuits being initiated against the directors. Because of the importance of the position and the extensive qualifications necessary, the appointment process is necessarily slower than desired.

For additional information, please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 30:

SDCERS should continue to develop and implement a comprehensive training program for its trustees and staff, including training in pension finance and investing and in prudent trustee requirements. It should report quarterly on these training activities.

Response 30:

Please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 31:

SDCERS, in conjunction with the City management, should evaluate the communication process and information flow between SDCERS and the City and adopt necessary modifications, if any, to this process to ensure the complete and timely flow of pension and benefit-related information to the City necessary for fiscal planning and the preparation of the City's financial statements.

Response 31:

The City concurs with this recommendation and notes that several mitigating procedures have already been put in place. These procedures include monthly meetings between the SDCERS CFO and the City Comptroller and a mutual review of each entity's CAFR prior to issuance. Additionally, the two organizations regularly communicate as necessary concerning issues of mutual interest. Management recognizes, however, that effective communication is sometimes hampered by ongoing litigation between the two entities. As part of the DPWG's review of the City's 2006 CAFR, SDCERS' CFO participated in the DPWG meeting in order to respond to questions from DPWG members. Questions focused on those areas of the City's CAFR where information was obtained from SDCERS' CAFR.

For additional information, please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 32:

SDCERS should report quarterly on the actions taken to remediate its failures to comply with applicable legal requirements and to ensure that similar failures do not reoccur.

Response 32:

Please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 33:

The City, working with SDCERS and with the assistance of an experienced pension consultant, should explore the range of alternatives for funding the City's pension and post-retirement benefits commitments. Alternatives might include, for example, funding alternatives, reduction or freezing of benefits, or establishing, as some private entities have done, a separate employee/union controlled plan that relieves the employer of further obligations. While all such alternatives are subject to legal, contractual and employee relation considerations, a comprehensive report should be issued by December 31, 2008.

Response 33:

The City concurs in this recommendation. The City has taken significant steps to reduce its pension obligations and its post-retirement benefits commitments. The City is funding not only its full pension yearly obligations but also paying in excess of its Annual Required Contribution. The City is also proposing a new pension system for new employees that reduces future City costs significantly. Based upon court decisions, reduction of obligations for existing employees has not been possible. The City has also reduced post-retirement commitments. By agreement effective July 2005, the City eliminated retiree health benefits. The City has also taken steps to fund its current health benefits by establishing a trust that with CalPERS and has deposited approximately \$30 million into this account during fiscal year 2008.

For additional information, please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Recommendation 34:

SDCERS' plan actuary should perform an experience study to assess the correctness of the actuarial assumption being used as promptly as practical but within 120 days. This and future experience studies, as well as future actuarial reports, should reflect the effect of the DROP program.

Response 34:

Please refer to SDCERS' response to the First Annual Report of Independent Consultant to the City of San Diego dated March 27, 2008 (**Attachment 2**).

Training

Recommendation 35:

The City, with the involvement of the DPWG and the IBA, as applicable, should develop within 90 days a comprehensive and coordinated training program for City officials and personnel on disclosure and financial reporting and then should report quarterly on the implementation and effectiveness of that program and any changes made to it.

Response 35:

The City concurs with this recommendation. In December 2006, the City Council adopted a comprehensive financial training program developed by the Office of the Independent Budget Analyst (IBA) at its request. Trainings to date covering disclosure (March 2007) and financial reporting (April 2007) have effectively been coordinated with certain members of the DPWG and City fiscal/legal consultants. The City Council training program is comprehensive for elected official needs/purposes; systematic in requiring that certain important financial topics be covered once every two years; and available to City staff/public live and via 7/24 replay on the City's website.

A panel including representatives from the DPWG, the IBA, and financial management will review the current training programs for the City Council and City staff. The panel will make recommendations regarding the current training programs and implement changes, if any, within 45 days.

Fiscal Integrity

Recommendation 36:

The City should assess the value of its current Five-Year Financial Outlook as a planning tool, and consider use of additional planning tools, for ensuring that the City is able to meet its goals for providing services to the citizens of San Diego at a cost they are willing to bear.

Response 36:

The City's Five Year Financial Outlook (Outlook) provides the framework for informed budgetary planning and the adoption of the City's annual budget. The City currently works with state and regional agencies to incorporate relevant economic research and policy trends to inform the City's forecast. The City incorporates this research and continual in-house analysis in periodic updates to the Outlook throughout the year as economic conditions and demands on city resources change to keep the forecast relevant to current conditions. The City continues to evaluate best practices for long term fiscal planning and intends to implement any enhancements that can be realistically supported by available resources.

Additionally, IBA Report #08-9 (**Attachment 3**) noted items that were not considered in the Outlook which are likely to impact the City's General Fund. The IBA Report also compared the City's Outlook to other municipal forecasts and suggested common features that could add value in future updates (i.e., a discussion of risks). City management has reviewed the IBA's recommendations and indicated that they will consider incorporating these recommendations into the next Outlook.

The City will continue to work with the Independent Consultant to not only implement these recommendations but also to go beyond in order to ensure that the City continues to establish best practices in its financial reporting and ultimate disclosure.

Sincerely,

JERRY SANDERS
Mayor

SCOTT PETERS
City Council President

Attachments

Cc: Honorable Members of City Council/Audit Committee Members
Michael Aguirre, City Attorney
Stanley Keller, Independent Consultant
Jay M. Goldstone, Chief Operating Officer
Andrea Tevlin, Independent Budget Analyst

000685

REQUEST FOR COUNCIL ACTION
CITY OF SAN DIEGO

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

330
05/06

TO:
Council Attorney

2. FROM (ORIGINATING DEPARTMENT):
Office of the Mayor

3. DATE:
April 25, 2008

4. SUBJECT:
Response to the Report from the Independent Oversight Monitor

5. PRIMARY CONTACT (NAME, PHONE & MAIL STA.)
Ed Plank 236-6433

6. SECONDARY CONTACT (NAME, PHONE & MAIL STA.)
Jay Goldstone 236-5941

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	ORIGINATING DEPARTMENT	<i>Edward Plank</i>	4/25/08	8				
2				9	COO	<i>[Signature]</i>	4/25/08	
3				10				
4				11				
5				DOCKET COORD: _____ COUNCIL LIAISON: _____				
6				✓	COUNCIL PRESIDENT <input checked="" type="checkbox"/>	SPOB <input type="checkbox"/>	CONSENT <input type="checkbox"/>	ADOPTION <input checked="" type="checkbox"/>
7					REFER TO: _____	COUNCIL DATE: 5/6/08		

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

1. Please docket for discussion the Mayor's response to the Annual Report from Mr. Stanley Keller, the Independent Oversight Monitor, and
2. Authorize the Council President to co-sign the response prior to its submittal to the Securities and Exchange Commission.

11A. STAFF RECOMMENDATIONS:

Review the response and authorize Council President Peters to co-sign prior to submittal to the SEC

12. SPECIAL CONDITIONS:

COUNCIL DISTRICT(S):

COMMUNITY AREA(S):

ENVIRONMENTAL IMPACT:

HOUSING IMPACT:

OTHER ISSUES:

000687

EXECUTIVE SUMMARY SHEET
CITY OF SAN DIEGO

DATE ISSUED: April 25, 2008 REPORT NO:
ATTENTION: Council President Peters and City Council
ORIGINATING DEPARTMENT: Mayor Sanders Office
SUBJECT: Response to Report from the Independent Monitor
COUNCIL DISTRICT(S):
CONTACT/PHONE NUMBER: Ed Plank/ 236-6433

REQUESTED ACTION: Docket for City Council discussion the Mayor's response to the annual report from Mr. Stanley Keller, the Independent Oversight Monitor and authorize Council President Peters to co-sign the response prior to its submittal to the Securities and Exchange Commission.

STAFF RECOMMENDATION: Authorize Council President Peters to co-sign the Mayor's response to the Annual Report.

EXECUTIVE SUMMARY: The 2006 Report of the Audit Committee of the City of San Diego (the "Kroll Report") and the Cease and Desist Order of the United States Securities and Exchange Commission issued in November 2007 established an Independent Monitor/Consultant to oversee and report on the City of San Diego's implementation of remedial actions included in the Kroll Report's recommendations and as required by the SEC. Mr. Stanley Keller with the firm Edwards Angell Palmer & Dodge LLP was contracted to serve as this Independent Monitor in January 2007.

Mr. Keller issued the First Annual Report of the Independent Consultant to the City of San Diego, dated March 25, 2008. The report is attached.

The Mayor's Office, with input from the Office of the Independent Budget Analyst and the Disclosure Practices Working Group, has prepared a response to Mr. Keller's Report. This response is being provided for review by the City Council with a request for the Council President to be authorized to co-sign the response prior to its submittal to the United States Securities and Exchange Commission.

FISCAL CONSIDERATIONS:

PREVIOUS COUNCIL and/or COMMITTEE ACTION:

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:

KEY STAKEHOLDERS AND PROJECTED IMPACTS:



Chief Operating Officer

000689

First Annual Report of Independent Consultant

to the

City of San Diego

March 25, 2008

Stanley Keller

Edwards Angell Palmer & Dodge LLP

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First Annual Report of Independent Consultant to the City of San Diego

I. Introduction

This is my First Annual 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"). The Agreement also provides for me to act as Independent Monitor 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. I issued my Initial Report required by the Agreement and the SEC Order on June 7, 2007. It described my activities as Independent Consultant and Independent Monitor. The Initial Report also made certain recommendations based on these activities. As provided in the Agreement and the SEC Order, this First Annual 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 after the second and third anniversaries of my appointment.

This Report contains recommendations, both those included in the Initial Report and those developed subsequently, concerning, among other things, the City's policies, procedures and internal controls regarding its disclosures for offerings, including disclosures made in its financial statements, pursuant to continuing disclosure agreements and to rating agencies, with a view to assuring compliance with the City's disclosure obligations under federal securities laws. It also includes my assessment and report on compliance by the City with those policies, procedures and internal controls and whether it has adopted recommendations previously made. Under the SEC Order, the City is to implement those recommendations or alternatives that the Mayor and City Attorney certify they reasonably believe are expected to achieve the same objectives.

My Initial Report focused on my activities both as Independent Consultant under the SEC Order and as Independent Monitor under the Kroll Report, with emphasis on the latter because of the nature of my activities at the outset of my engagement. This Report deals solely with my role as Independent Consultant.¹ I have been assisted in my activities by lawyers and other personnel in my law firm, most notably Walter St. Onge, an expert in municipal finance law. I also have been assisted by Rod LeMond of McGladrey & Pullen LLP based in Riverside, California, who I retained to provide independent governmental accounting and auditing expertise. McGladrey & Pullen is a leading national accounting and auditing firm with recognized expertise in governmental accounting and auditing.

¹ 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, and I have not done so.

II. Summary of SEC Order

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 concluded 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 or suspended the City's credit ratings. The City also was unable to timely provide 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. The SEC recently stated that its investigation is ongoing as to individuals and entities that may have violated federal securities laws.

III. Objectives of Remedial Action

As noted in the Initial Report, over two decades ago, 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 imposed upon the municipal securities world, resulting in SEC Rule 15c2-12 and an increased focus on antifraud enforcement. Rule 15c2-12, as amended, mandates that an underwriter obtain from the issuer and review a final official statement, as defined in the rule, 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.

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, there is now 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. As noted in my Initial Report, this opportunity has been embraced by key officials within the City 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, with appropriate modifications.

IV. Subject Matters Addressed

My activities have involved analyzing, assessing and making recommendations with respect to specific areas that relate to the adequacy of the City's disclosures, financial reporting and internal control structure. These are discussed below and specific recommendations with respect to each area are set forth. Because any work, by necessity, took place as of a specific date and the City's remediation efforts are ongoing, there may be subsequent developments that are not reflected. In addition, because the City has not yet been in a position to return to the public markets for financing, I have not been able to observe its disclosure processes and controls in that context. I expect to do so before my next report.

Governmental Structural Changes

The City took a number of actions to modify its governmental structure following the events that led to the SEC investigation and prior to my engagement. Significantly, 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 an experienced Chief Financial Officer, who has since become Chief Operating Officer, and a new CFO has been appointed. 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 following the events that led to the SEC investigation.

At the same time, an office of Independent Budget Analyst ("IBA") was created 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 were significantly enhanced by the appointment of a Deputy City Attorney for Finance and Disclosure with background and experience in municipal finance and municipal disclosure, in addition to two deputy city attorneys assigned to this function. In addition, the City retained new outside disclosure counsel with extensive qualifications.

As described below, the City took a number of other steps to improve its disclosure process, including creating a Disclosure Practices Working Group and adopting Disclosure Controls and Procedures, requiring senior officials to certify the accuracy of the City's disclosures, providing for an annual evaluation and report on the City's internal financial controls by the City's Auditor and Comptroller, and instituting training program for City officials and staff.

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. Following its formation, the Audit Committee began the process of organizing itself and increasing its capabilities to carry out its functions.

Financial Control Structure

Audit Committee

My Initial Report made a number of recommendations to strengthen the effectiveness of the Audit Committee established by the City Council to oversee the City's financial reporting and internal control structure. Many of these have been accomplished, including adoption of an ordinance setting forth the Audit Committee charter, creation of a three person citizen's advisory group to provide expertise, and retention of a professional consulting firm with experience in accounting and auditing, Jefferson Wells. As provided in the Audit Committee's charter, its purpose 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.

Certain of these arrangements were viewed as interim measures pending revision of the City Charter to permit a restructured Audit Committee with financial and accounting expertise within its membership.

A Charter Review Committee made recommendations for Charter revisions, one of which deals with creation of an Audit Committee with citizen members. The City Council has approved submitting for voter approval in June 2008 a package of Charter revisions, one of which would establish a reconstituted Audit Committee. Under the proposal, the Audit Committee would consist of two Council members, one of whom shall be chair, and three citizens with financial and accounting expertise appointed by the Council from a pool of candidates recommended by a screening committee. This proposed revision is consistent with my recommendation that an Audit Committee be created that is independent, has relevant expertise and has a relationship with the City Council given the Council's role in the City's financial reporting.

Recommendation:

The City should submit to the voters for approval in June 2008, and timely take all action to meet that schedule, the establishment of an Audit Committee that meets the following criteria:

- *Has the requisite independence from financial management.*
- *Has the requisite expertise to perform its oversight functions.*
- *Has a sufficient relationship with the City Council to engender its confidence in view of the Council's role in the City's financial reporting.*

Internal Audit Function

In my Initial Report I focused on the critical role of the internal audit function, which at that time had virtually disappeared within the City. I worked with the City to establish based on a Statement of Operating Principles an internal audit function with a direct relationship with the Audit Committee so that internal audit could operate with independence across the range of functions required of that office. It was recognized that this was an interim arrangement pending Charter revision to create a truly independent internal audit function. After appointing a temporary internal auditor, following a search process that involved the Audit Committee and the IBA, the Mayor, in consultation with the Audit Committee, appointed an internal auditor with professional qualifications to serve in this position under the interim arrangement.

The Charter Review Committee proposed, consistent with my recommendations, separating the audit and comptroller functions now under the Auditor and Comptroller and creating a separate office of City Auditor to perform the internal audit function with direct reporting responsibility to the Audit Committee. There was significant debate on the method of

selection of the City Auditor. I expressed the view that there were several acceptable alternative methods of selection, with the important objective being to create an effective and independent internal audit function on a timely basis. The City Council approved submitting to the voters in June 2008 a revision of the City Charter which will create a separate office of City Auditor who would be nominated by the Mayor, in consultation with the Audit Committee, and would be subject to confirmation by the City Council. The City Auditor would have reporting responsibility to the Audit Committee and tenure to ensure independence from management. This proposed revision satisfies the criteria of my recommendation.

Although efforts have been made to reestablish an operational internal audit function, the internal audit office is currently inadequately staffed. If this office is to perform its responsibilities effectively, the City needs to devote significant resources to the internal audit function and the internal audit staff needs to be significantly expanded. The Audit Committee professional consultant recently issued a report analyzing, among other things, the staffing needs of the internal audit function. The Mayor has indicated that five new positions will be included in the fiscal 2009 budget. This is a beginning but more resources will be required over time if the City Auditor is to fulfill the internal audit responsibilities.

Recommendation:

- *The City should submit to the voters for approval in June 2008, and timely take all action to meet that schedule, the creation of an office of City Auditor that is separate from the current office of Auditor and Comptroller and with direct reporting responsibility to the Audit Committee.*
- *The City should begin the process of significantly increasing the staffing of the internal audit function in order to permit effective internal auditing to be accomplished, including an assessment by the internal auditor of staffing needs, and should periodically report its progress to the Audit Committee.*

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 financial and auditing matters, in each case on a confidential and anonymous basis if so desired by the reporting person. The City has a hotline operated by the Office of Ethics and Integrity and utilizing a third party provider. However, the hotline operation can be improved to ensure its independent operation and effective oversight. Recommendations have been made by the Audit Committee professional consultant, including direct reporting to the Audit Committee of hotline activity involving improper financial conduct and fraud, waste and abuse and hotline monitoring, with increased monitoring and reporting responsibility for the City Auditor following Charter revision.

Recommendation:

- *The City should implement within 45 days, consistent with the advice of Jefferson Wells for steps prior to Charter revision, the procedure contemplated by the Audit Committee charter for a confidential and anonymous hotline involving the Audit*

Committee independent of City management for complaints and concerns regarding financial control or financial and auditing matters.

Improper Influence Ordinance

The Kroll Report recommended that the City adopt an ordinance making it unlawful 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 financial reporting. A draft ordinance patterned after Section 303 of the Sarbanes-Oxley Act and SEC Rule 13b2-2 has been prepared but appears stalled, apparently over concerns that there be proper safeguards to insure that the ordinance is properly used and rights of the accused adequately protected, and over issues regarding the enforcement authority, particularly considering the important role of the City Attorney in the disclosure process. These concerns and issues should be resolved expeditiously so that the ordinance can be adopted as promptly as practicable.

Recommendation:

- *The City should address any remaining issues expeditiously so that an improper influence ordinance can be adopted as promptly as practicable.*

Focused Financial Management Responsibility and Accountability

The City's financial disclosure problems in the past were in part attributable to diffuse financial management responsibility. The City has taken some steps through appointment of a Chief Financial Officer (CFO) to address this problem. However, the City needs to complete the actions necessary to accomplish this by submitting to the voters Charter revision that not only separates the audit and comptroller functions now located with the Auditor and Comptroller but establishes clearly the position of CFO with focused responsibility and accountability for the City's financial reporting.

Recommendation:

- *The City should submit to the voters for approval by June 2008, and timely take all action to meet that schedule, the separation of the Auditor and Comptroller position into two and the creation of the position of Chief Financial Officer in order to focus responsibility and related accountability for the City's financial reporting.*

Internal Controls Remediation

The City is engaged in a process to strengthen its internal controls, including internal controls over financial reporting (ICOFR), and to remediate internal control weaknesses identified by the Kroll Report, the Yellow Book² reports of its independent auditors and the annual reports of the City Auditor and Comptroller.

² Refers to the Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards.

In reality, there had been two processes underway – one related to the enterprise resource planning (ERP) process and the other focused on the City ICOFRs. Until recently, there appears to have been insufficient coordination between the two processes, and this lack of coordination, if not overcome, would likely impede the effectiveness of each and result in inefficiencies. Recently, the City has reorganized management of this effort and taken steps to increase coordination. Since this coordination has only recently begun, its effective implementation still needs to be shown. Moreover, there are questions whether the City is devoting sufficient resources to its ICOFR effort and is being realistic about the timeline for the ICOFR effort and the ERP process, especially given the need for their integration.

The ERP process involves City information technology personnel, with the assistance of an outside consultant. A key initial phase of the ERP process is the blueprint alignment or mapping activity that is a precondition to launching system applications. This phase consists of a thorough analysis of requirements and business processes to be supported by the ERP system. It is the foundation for succeeding phases and is designed to (i) define how existing processes and controls operate, (ii) define how the processes, as modified and remediated, will work under the ERP system and (iii) map how to get from (i) to (ii) procedurally and programmatically. The blueprint phase for the financial information and procurement applications is in process and is scheduled for completion shortly. The City will have to coordinate this with the overlapping ICOFR effort.

The City's ICOFR process is designed to identify the critical accounting and reporting processes that enable preparation of the City's Comprehensive Annual Financial Report (CAFR), determine the necessary relevant controls and assess when these controls are in place and operating as intended. The City, in one analysis by financial personnel, identified 131 critical accounting and reporting processes that support preparation of the CAFR. Based upon a prioritization analysis, influenced by which processes will be affected by installation of the ERP system and thus might wait upon that, the City has begun to document these processes as a means to identify the relevant internal controls necessary for reliable financial reporting. Financial management estimated that 5,000 hours will be necessary to document the processes. The City's ICOFR approach is consistent with the approach to identifying critical processes recommended by the Committee of Sponsoring Organizations (COSO) and the approach now recommended for SEC reporting companies by Auditing Standard No. 5 and the related SEC guidance for management. This represents a change from the bottom-up process followed initially by the City that focused on detailed documentation of all processes rather than focusing on those most critical. The approach the City now is following includes a quantitative and qualitative assessment of the financial statements, taking into account the financial reporting objectives, to determine significant accounts that present the greatest risk of reporting errors and the underlying processes that support those accounts and the financial reporting objectives.

It is obvious that the ICOFR effort of identifying the significant accounts and documenting the critical processes that support them significantly overlaps with the important blueprint phase of the ERP process. Yet, initially there appeared to be only limited coordination taking place between the ICOFR process and the ERP process. This coordination, which the City has begun to implement, is necessary in order to align the objectives of these processes, define reasonable schedules for implementing these processes and maximize utilization of available resources.

The City's assessment under the ICOFR process of significant accounts and underlying processes has been focused at the top-level, government-wide financial statements included in the CAFR. However, under Governmental Accounting Standards Board (GASB) standards, a CAFR of a governmental entity is intended to serve various purposes and the interests of various constituencies by including multiple financial statements by different fund types, some with different accounting methods, which through a final reconciliation process result in the government-wide or top-level financial statements. Accordingly, the assessment process to determine significant accounts and underlying processes, and therefore the necessary controls and remediation, must be more granular by considering the reporting objectives of the individual financial statements that comprise the CAFR in order to ensure reliable financial reporting.

In view of the long-term nature of the ERP and ICOFR processes, it is desirable to consider on a more immediate basis the adequacy of the process for financial statement preparation currently in place and the feasibility of interim external checks to assure that adequate remediation progress is being made. To date, the City's independent auditors have been able to satisfy themselves through compensating audit procedures that, despite the identified internal control weaknesses, they could issue their reports on the City's CAFR. In order to support management's assertion in the financial statements prepared prior to completion of the planned remediation efforts, the City should consider other remediation options to deal with the gap. One option would be to develop effective "period-end" financial reporting routines that would be incorporated into the financial statement closing process. These routines, which serve to identify and capture the information necessary to achieve financial reporting objectives, utilize checklists, involve account analysis, reconciliations and journal entry identification and require technical reporting skills and significant supervisory oversight. In many situations, these period-end routines effectively compensate for the lack of system or process controls that otherwise would be necessary. A period-end reporting routine would be consistent with the applicable Kroll recommendation.

As another measure, the City should pay particular attention to prioritizing the remediation efforts to address the most critical needs as promptly as possible. Following the top-down, risk assessment approach can facilitate this prioritization and permit progress to be made more rapidly without waiting for completion of a comprehensive effort.

Recommendations:

- *The City needs to better integrate and coordinate its ERP process and ICOFR process in order to align their objectives, maximize utilization of available resources and achieve optimum results. This should be addressed (to the extent it has not been), with identification of defined tasks, specific individuals with responsibility and specific resources to be employed, within 45 days.*
- *The City needs to devote additional resources to the ICOFR process if the internal control remediation activities are to be completed within a reasonable time frame. The City should consider hiring an outside consulting firm with experience in developing, implementing and remediating an internal control structure within a governmental entity. These efforts should be assessed quarterly to determine if adequate progress is being made.*

- *The City should establish a reasonable schedule and budget for developing and implementing installation of the ERP system that takes into account integration of the ICOFR process. This should be done within 60 days.*
- *The City should continue to take a top-down, risk-based approach to remediating its internal control weaknesses as a more effective way to timely identify critical internal control processes, and should address the deficiencies and weaknesses identified in the Kroll Report, the Yellow Book reports and the Auditor and Comptroller annual reports, but should go beyond these to look at internal controls on a comprehensive basis. These efforts should be assessed quarterly.*
- *In assessing significant accounts and underlying processes as part of the ICOFR process, the City needs to look below the top-level, government-wide financial statements to the individual financial statements that comprise the CAFR. This should be done within 60 days.*
- *The City should consider interim remediation options to enhance confidence in the reliability of financial reporting in the near term, including development of period-end financial reporting routines. The City also should prioritize its remediation efforts to address the most critical needs as promptly as possible. It should report to the Audit Committee on the progress of these efforts at least quarterly.*

Financial Reporting Enhancements

Review of CAFRS

The Audit Committee plays an important role in reviewing the City's CAFR as part of the procedure to ensure reliable financial reporting and disclosure. In this role, the Audit Committee, following its review, transmits the CAFR to the City Council. The Audit Committee has adopted procedures for this review. These procedures were followed in the case of the 2003 CAFR and 2004 CAFR, which were forwarded to and received and filed by the City Council, and the 2005 CAFR, which has been forwarded by the Audit Committee to the City Council and is pending before it. The 2006 CAFR has just been completed and forwarded to the Audit Committee for review. With the benefit of its experience in reviewing City CAFRs and with the advice of its experts and consultants, it would make sense for the Audit Committee, as part of its oversight responsibility over financial reporting, to periodically review its CAFR review procedures.

Recommendation:

- *The Audit Committee, with the assistance of its ad hoc advisory group and its professional consultant, should review within 45 days and improve as necessary its procedures for review of the City's CAFR to determine if any improvements should be made to those procedures.*

Shelf-Like Disclosure System

Improvement in the quality of the City's CAFR, coupled with periodic update information, can form the basis for both useful reporting to the financial marketplace and timely and efficient access to the capital markets when necessary. The City, with the assistance of the DPWG, should strive to establish a shelf-like disclosure system akin to the one that has worked so well in the private sector for larger publicly-held companies. The key factors in such a system are (i) annual reports that, through effective disclosure controls and procedures, provide reliable, quality financial information and disclosure, (ii) periodic and current reporting to keep that disclosure up-to-date, (iii) access to that information electronically and (iv) incorporation of that information into offering documents (either electronically or by physical attachment). In this way, the City will be able to go to market quickly when conditions justify by focusing on any required updates to the information and a description of the terms of the offering.

In planning for reentering the public market, the City should evaluate the relation of the CAFR to the offering disclosure document and, in that connection, should evaluate the component parts of the CAFR, including the role and coverage of the Letter of Transmittal.

Recommendation:

- *The City, with the assistance of the DPWG, should evaluate within 6 months the desirability of a shelf-like disclosure system to improve the quality and timeliness of its reporting to the financial markets on an ongoing basis and to permit the efficient access to the capital markets for needed financing.*
- *The City, with the assistance of the DPWG, should, in connection with planning to recenter the public market, evaluate the relation of the CAFR to the offering disclosure document and, in particular, should consider no later than in connection with the 2007 CAFR the role and coverage of the Letter of Transmittal in relation to the CAFR, with a view to eliminating unnecessary repetition and discussion.*

Improved Discussion and Analysis

The City should improve the quality of the discussion and analysis related to its CAFR so that there is meaningful analysis that facilitates an understanding of the financial statements and the City's financial condition, financial results, liquidity and capital needs, with the following principal objectives:

- Enhance overall financial disclosure and provide the context for analyzing and understanding the financial statements, including relevant information not reflected in the financial statements.
- Provide information about the quality and potential variability of the City's fiscal results and liquidity so that readers can ascertain the likelihood that past results are indicative of the future and appreciate the future challenges, demands and risks facing the City as indicated by known trends and uncertainties.

- Provide a narrative explanation that enable the reader to see and understand the City through the eyes of City management.

This analysis in the corporate world is required in the Management Discussion and Analysis (MD&A), and the City, in consultation with its independent auditor, should determine whether to include this analysis in the MD&A or Letter of Transmittal.

Recommendation:

- *The City, no later than in connection with its 2007 CAFR, should improve the quality of its financial disclosure by providing an analysis, either in the MD&A or Letter of Transmittal, as appropriate, that facilitates an understanding of the City's financial statements and its financial condition, financial results, liquidity and capital needs, including the risks faced by the City.*

Disclosure of Contractual and Off-Balance Sheet Obligations

Disclosure for private sector public companies has evolved to include tabular information showing future contractual and off-balance sheet obligations and other commitments by relevant time periods to supplement the information required in financial statements. This information would provide in one place an indication of what the City's capital and liquidity requirements are going forward and, therefore, the amount of revenues it will need either from internal or external sources.

Such a table, in either the Letter of Transmittal or MD&A, could include such items as debt service (principal and interest) obligations, capital and operating lease obligations, pension and post-retirement benefit obligations, purchase commitments and other contractual obligations, and other long-term liabilities shown on the statement of net assets. These items could be shown for relevant time periods such as within one year, one to three years, three to five years and more than five years, and with totals.

Recommendation:

- *The City, beginning with the 2007 CAFR, should include, in either the Letter of Transmittal or MD&A, a tabular presentation of its contractual and off-balance sheet obligations and other commitments shown by relevant time periods and with totals.*

Loss Contingencies and Risk Assessments

An important element of financial reporting is identifying and assessing litigation and other loss contingencies. This is governed by Financial Accounting Standards No. 5 (Accounting for Contingencies). Lawyers play a unique role in the process because of the legal matters involved. In the City, this would involve the City Attorney Office. Lawyer's responses to auditors regarding loss contingencies are handled under a well-established process, but as a management matter there must be effective systems and controls in place to catalogue, assess and retrieve information about claims. The City's independent auditors have noted deficiencies in this area. To the extent not already done, those deficiencies should be remedied.

Recommendation:

- *The City, through the City Attorney Office, should, prior to the preparation of the 2007 CAFR, improve its systems for dealing with loss contingencies for financial reporting purposes in order to remedy any deficiencies not by the City's independent auditors to the extent not already remedied.*

Disclosure Practices Working Group (DPWG)

The DPWG plays an important role in ensuring the quality and reliability of the City's disclosures. If it is to succeed in this role, it is critical that the DPWG operate in a professional, cooperative and non-political manner. While there are legitimate issues and differences in views that should be debated in the public arena and the need for appropriate checks and balances, the DPWG, as an important operating group within the City's organization, can best serve its purpose as a vehicle for ensuring accurate, complete and quality disclosure if it operates on a collaborative basis, vetting key issues as part of the disclosure process. It is the responsibility of all members of the DPWG to see that this is the case.

Although the DPWG often functions well, it sometimes suffers from a lack of continuity that impedes efficiency and effectiveness. This problem can be addressed through regularly scheduled meetings with sufficient advance notice, appointment of designees in a position to regularly participate, and definition of the scope of the DPWG's responsibilities more realistically as discussed below. The DPWG's 2007 annual report recognizes the need for some of these improvements,

In my Initial Report, after consultation with various City officials and DPWG members, I recommended certain changes in the composition of the DPWG and other changes to the Municipal Code provisions pertaining to the DPWG. The City Council approved these changes in April 2007, subject to adoption of a definitive ordinance, which recently occurred. One of the issues that arose in connection with adoption of the ordinance was the composition of the DPWG. I previously indicated my view that the DPWG is best viewed from an operational perspective in developing and ensuring the quality of the City's disclosure, much like a "disclosure committee" in the private sector as suggested by the SEC and now followed as best practices by most public companies. Viewed from this perspective, it is appropriate for the DPWG to be composed of those who have the responsibility for disclosure, so that they both are involved in the process and are accountable. Actual DPWG membership, as opposed to participation, is related mostly to voting, and voting should not normally be the DPWG's method of operation. In fact, the DPWG ordinance could be revised in the future to eliminate the concept of voting. The necessary checks and balances in the disclosure process should be derived from the DPWG's participatory process, the need for different officials within the City to be involved in the City's disclosures and the oversight provided by the Audit Committee and, ultimately, the City Council.

With the ordinance revising the Municipal Code having been adopted, the appropriate members of the DPWG should now complete appointment of designees, if desired, and the DPWG should continue to establish a regular meeting schedule well in advance, as it has begun to do, in order to assure the availability of quorums and, perhaps more importantly, continuity among the members of the DPWG with respect to the matters discussed and reviewed at its

meetings. In addition, conforming changes to the Disclosure Controls and Procedures of the DPWG should be made, together with any other revisions considered necessary or desirable by the DPWG. The DPWG is in the process of making these changes.

Section 22.4106(a)(3) of the Municipal Code, as recently amended, provides that the DPWG shall submit an annual report to the City Council and Audit Committee on or before December 15 of each year, which is to include an assessment of the effectiveness of the disclosure controls and procedures. The DPWG also is to recommend changes to the disclosure controls and procedures to the extent necessary to improve their overall effectiveness.

Specifically, the DPWG should continue to review its practices and those of appropriate City officials with respect to the dissemination of press releases, website postings and other communications, such as media interviews, press conferences and similar media items, reasonably expected to reach investors or the securities markets to determine the extent to which DPWG advance review of these items is realistic. Section 22.4107(a)(1) of the Municipal Code currently refers to such material as included within the scope of the DPWG's review of the form and content of disclosures. In view of today's near instantaneous availability of information via the internet, as well as the practical need for City officials to be available to the public and media to address any and all matters affecting the City, it appears that the DPWG is given limited, if any, opportunity to review such matters prior to actual dissemination. While it may be debatable as to whether any particular communication is *intended* to reach investors or the securities markets, it is likely that most of them do. It is also likely that many of them are received as the normal communications of a large American city and not specifically intended to provide information to investors or markets. Moreover, it is obvious that the DPWG cannot perform a review function for communications it does not receive. Accordingly, the DPWG should evaluate the desirability of modifying its practices and procedures so that the communications it is required to review comports more with the realities of City operations and still meet its disclosure responsibilities.

In addition, in order to identify which documents have been reviewed by the DPWG and are official documents of the City intended to reach investors and the securities markets, the City should complete the effort begun to restructure its website so that there is a separate portal identified for this purpose, such as "Information for Investors." Only documents that have been approved by the DPWG and issued as official City documents would be included in this portal. For example, a CAFR would not be included in this portal until it has been received and filed by the Council and thus officially issued. This portal also could include an archive section to which outdated information could be transferred. The portal could include a legend identifying its purpose and disclaiming other documents from being official communications of the City intended for investors or the market. These other documents, to the extent there is uncertainty as to their status, could bear a legend indicating their status with an appropriate disclaimer. Also, the opening page of the City's website could advise that the only information posted on the website with the intention of reaching investors is that posted on the "Information for Investors" webpage.

Recommendations:

- *City officials should, to the extent they have not done so, appoint designees to the DPWG within 30 days to ensure availability of quorums and continuity from meeting to meeting.*
- *The DPWG should continue to establish a regular meeting schedule.*
- *Any necessary changes to the Disclosure Controls and Procedures to reflect changes to the Municipal Code should be effected within 45 days.*
- *The DPWG should assess the effectiveness of its review of the form and content of "press releases, ... web-site postings, and other communications reasonably likely to reach investors or the securities markets" as set forth in Section 22.4107(a)(1) of the Municipal Code and within 45 days recommend changes, if any, to reflect actual practices within the City.*
- *In connection with the foregoing, the City should revise its website within 90 days to have a dedicated portal where official documents reviewed by the DPWG can be posted.*
- *The DPWG should, as required by the Municipal Code, continue to assess at least annually the adequacy of its existing processes and propose modifications to enhance the efficiency and overall effectiveness of its operations.*
- *The DPWG, in conjunction with City financial management and the IBA, should assess the current training program for City officials and staff and recommend and implement changes, if any, within 45 days.*

Role of Counsel in Legal Compliance

It is widely recognized that counsel plays a critical role in legal compliance by an organization, such as the City. See, for example, the SEC Part 205 Rules and related releases, Report of American Bar Association Task Force on Corporate Responsibility and Report of the Bar of the City of New York on the Role of Corporate Counsel. In order for counsel to play that role effectively, there needs to be a mutual relationship of trust and confidence between counsel and the representatives of the organization charged with managing its affairs and implementing its policies. This permits the representatives of the organization to have the necessary confidence to consult counsel with knowledge that counsel is acting in the best interests of the organization as the client and providing objective legal advice. Only with such a relationship will counsel be consulted and be in a position to advise effectively on legal compliance based upon full knowledge of all the facts. When that bond of trust and confidence is broken, the chances increase that representatives of the organization will take action without the benefit of reliable advice of counsel designed to ensure legal compliance. Trust and confidence is an important requirement for effective governance throughout the City and one that has to be earned through sustained efforts by all parties involved. The focus of this section is on the need for mutual trust and confidence between counsel and City officials in need of legal advice in order to

foster a climate that promotes legal compliance. The City Attorney is the chief legal officer of the City and plays a crucial role in ensuring legal compliance, particularly in an independent capacity. However, the City's governance structure, because of the separately elected officials, contains a risk that the necessary mutual relationship of trust and confidence could be eroded. For various reasons, that in fact is what has happened within the City.

The Charter Revision Committee recommended addressing this structural problem by a Charter amendment to identify the City and its elected officials as the client of the City Attorney and to establish a procedure for the retention of other counsel when the City Attorney has an ethical or financial conflict. This recommendation was not followed. There are other alternatives that the City could consider. One alternative would permit the City Attorney, as a separately elected official, to independently define his or her role and constituency and would formally provide for appointed counsel, who would not replace the City Attorney as the City's chief legal officer, but rather would serve as a recognized legal counselor for other elected officials, possibly one for the Executive Branch and one for the Legislative Branch. This is not an unusual arrangement when there is a separately elected chief legal officer. For example, states often have an elected attorney general as a separate constitutional officer but also have separate counsel to the governor and to the legislature. Although lawyers may serve on the executive and legislative staffs, by having someone designated as counsel that person takes on the focused professional and ethical responsibilities that serve, in addition to the independent role played by the separately elected chief legal officer, to promote legal compliance. Any alternative also could provide formally for retention of outside counsel when necessary.

It is important to emphasize that the role of counsel in legal compliance does not stop at providing legal advice to a client, including advice on legal compliance. As recognized by the SEC Part 205 Rules and by state ethics rules, there are times when counsel, whether elected or appointed, must go beyond advising and is required to report possible wrongful conduct to a higher authority within the organization and, potentially, consistent with ethical confidentiality rules, outside the organization, including, if necessary, to regulatory officials. This obligation would apply under whatever approach is followed.

Recommendation:

- *The City should consider whether any steps are necessary to ensure the availability of legal counsel that will foster the ability of City officials to consult with and obtain legal advice based upon a relationship of trust and confidence designed to promote legal compliance.*

San Diego City Employees' Retirement System (SDCERS)

The Krill Report included a number of remediation recommendations related to SDCERS. Some of these recommendations still need to be addressed. In particular, as noted by the Administrator of SDCERS in a status report from August 2007, three matters were then pending before the City Council relating to (i) technical corrections ordinances, (ii) the proposed revised "waterfall" ordinance and (iii) approval of group trust participation agreements. Item (iii) has now been satisfied and items (i) and (ii) remain outstanding. The City Council should act promptly on these outstanding matters. In particular, the discussion of the various concerns

regarding changes to the "waterfall" ordinance could continue indefinitely, but not apparently with any new information being provided. Unless such new information is available, it is appropriate for the City Council to make a decision on this matter and take action. Other changes are considered technical corrections and there does not appear to be any real reason for further delay. In addition, the City Council should timely act on the matters required to be addressed under the December 18, 2007 compliance statement with the IRS.

The SDCERS Board of Administration currently has one vacancy and two holdover appointees among the members appointed by the Mayor. While it may be difficult to find qualified candidates to serve, the Mayor should make every effort to promptly fill these positions. The Board has established various committees and it will function best if it is able to operate with a full complement of members that reflects the careful balance contemplated by the reform efforts that led to the current composition of the SDCERS Board. The sooner a member is appointed, the sooner he or she will be able to actively participate and assist the Board in fulfilling its fiduciary responsibilities.

A potentially serious failure of internal controls over financial reporting occurred in connection with the preparation of the City's 2005 CAFR when there was a failure to have brought to the attention of City management information that the number of retirees who were receiving pension benefits in excess of IRS limits for benefits that may be funded through an actuarial accrued 401(a) pension plan and the amount of those excess benefits were greater than previously reported. As a result, this information was not reflected in the City's 2005 CAFR when it was initially issued. Although the matter subsequently got resolved through a settlement with the IRS that resulted in a compliance statement, and regardless of the materiality of the specific numbers, this was evidence of a breakdown in communication and financial reporting that needs to be remedied. Moreover, there was a demonstrated failure by SDCERS over a number of years to comply with applicable legal requirements, as indicated in its voluntary compliance filing with the IRS.

SDCERS recent actuarial valuations have shown that the City's pension plan has experienced liability losses in most of the years reported on. This could indicate that the actuarial assumptions used do not correctly reflect the anticipated experience of the plan. In view of these results, it would be appropriate for SDCERS to implement the planned experience study by the plan actuary as soon as practicable. In addition, the experience study and subsequent valuations should reflect the effect of the DROP program.

Recommendations:

- *The City Council should address within 30 days the "technical corrections ordinances and the "waterfall" ordinance. It also should act on the matters required by the compliance statement with the IRS within the time specified therein.*
- *To the extent necessary, SDCERS should be asked to adopt promptly any necessary amendments to its other "controlling documents" following final action by the City Council regarding the matters listed in the preceding recommendation.*

- *The Mayor should make reasonable efforts to appoint or reappoint trustees to fill the current vacant and holdover positions on the SDCERS Board within 90 days.*
- *SDCERS should continue to develop and implement a comprehensive training program for its trustees and staff, including training in pension finance and investing and in prudent trustee requirements. It should report quarterly on these training activities.*
- *SDCERS, in conjunction with the City management, should evaluate the communication process and information flow between SDCERS and the City and adopt necessary modifications, if any, to this process to ensure the complete and timely flow of pension and benefit-related information to the City necessary for fiscal planning and the preparation of the City's financial statements.*
- *SDCERS should report quarterly on the actions taken to remediate its failures to comply with applicable legal requirements and to ensure that similar failures do not reoccur.*
- *The City, working with SDCERS and with the assistance of an experienced pension consultant, should explore the range of alternatives for funding the City's pension and post-retirement benefits commitments. Alternatives might include, for example, funding alternatives, reduction or freezing of benefits, or establishing, as some private entities have done, a separate employee/union controlled plan that relieves the employer of further obligations. While all such alternatives are subject to legal, contractual and employee relation considerations, a comprehensive report should be issued by December 31, 2008.*
- *SDCERS' plan actuary should perform an experience study to assess the correctness of the actuarial assumption being used as promptly as practical but within 120 days. This and future experience studies, as well as future actuarial reports, should reflect the effect of the DROP program.*

Training

Training is an important part of a control structure designed to ensure legal compliance. My Initial Report described the actions on training undertaken by the City through the date of the report and those planned. Specifically, the DPWG has a role in ensuring that City officials and staff receive appropriate training, and the IBA has been directed by the City Council by an ordinance adopted in December 2006 to develop a comprehensive financial training program for Council members. In this connection, the DPWG developed training programs for Mayoral staff and other City employees and the IBA developed and has been implementing a financial training program for Council Members, assisted on disclosure-related topics by members of the DPWG. For example, training sessions were given on disclosure obligations under federal securities law, including review of the San Diego and other SEC municipal enforcement actions, by the City's outside disclosure counsel, assisted by the Deputy City Attorney for Finance and Disclosure, in March and April 2007 to the City Council, the Mayor and his senior staff, and City employees involved in disclosure and financial reporting. Also in April 2007, a training session was held

for the City Council on municipal financial statements presented by the City's outside auditor. In September 2007, a training session was given to the City Council by outside disclosure counsel, the Deputy City Attorney and staff of the Department of Debt Management on debt issuance and administration. In January 2008, a training session was given to the City Council on variable rate debt and derivative options. The IBA is planning on a training session in June 2008 and three more during the fiscal year ending June 30, 2009, one of which will cover current and multi-year budget planning and another, after new Council members are seated, will revisit disclosure obligations. Training sessions are recorded for future use and are available on the City's website for viewing.

I have identified elsewhere the need for the DPWG, as part of an ongoing process, to assess the current training program for City officials and staff and for SDCERS to develop and implement a comprehensive training program for its trustees and staff. In addition to the schedule for City Council member training developed by the IBA, the City should develop a regular schedule, on an annual-cycle basis, for training programs for City personnel, including repeat of previous training. This is important as refreshers for City officials and staff and in order to ensure training for new officials and staff.

A training program should focus in a practical way on the disclosure and financial reporting requirements of the federal securities laws and applicable accounting standards. It also should be targeted to the specific roles and responsibilities of the persons involved in the disclosure and reporting process. In addition, the training should be comprehensive in covering City executives and financial management, City Council members and their staffs, and other City employees involved in the disclosure and financial reporting process.

Recommendation:

- *The City, with the involvement of the DPWG and the IBA, as applicable, should develop within 90 days a comprehensive and coordinated training program for City officials and personnel on disclosure and financial reporting and then should report quarterly on the implementation and effectiveness of that program and any changes made to it.*

Fiscal Integrity

The City's fiscal problems were not created overnight and will not be solved overnight. As discussed in my Initial Report, fiscal integrity and reliable financial reporting and disclosure are closely intertwined because full and accurate disclosure can become a challenge when there are fiscal difficulties. The City now prepares an annual Five-Year Financial Outlook that serves an important planning role supplemental to the annual budget process. While the City should not be expected to resolve "out year" projected deficits in years one or two, it should seek to keep projected deficits within manageable bounds. The City should periodically review the assumptions underlying the Outlook and assess the accuracy of the Outlook over time. To the extent actual results vary significantly from the projections, the City should assess why those variances occurred and whether changes to its planning process are appropriate. Although longer term planning that simply extrapolates current results will likely not be useful, the City should look beyond the five-year outlook period to assess whether the five-year picture is indicative of

longer term trends and needs. The City should consider engaging a financial advisory firm experienced in dealing with municipal finance matters to assist it in evaluating its Outlook and longer term assessment, including through comparative analyses, and considering options to enhance their value as planning tools that assist the City in addressing its unfunded liabilities in the context of the other demands on City government.

Recommendation:

- *The City should assess the value of its current Five-Year Financial Outlook as a planning tool, and consider use of additional planning tools, for ensuring that the City is able to meet its goals for providing services to the citizens of San Diego at a cost they are willing to bear.*

V. Conclusion

The City has taken meaningful action to address various of the problems of the past and to begin to put control structures and procedures in place. However, much more needs to be done. The most progress has been made in establishing the structures needed for an effective disclosure and control environment, including a strong Mayor form of government with centralized responsibility and accountability, an Audit Committee to provide independent oversight, an independent and professional internal audit function, an effective DPWG and a revamped pension administration. These structural measures need to be completed and made permanent through Charter revision and, at least in the case of the internal audit function, require significant additional staff. Although the City has begun the process to improve its internal controls and procedures, less progress has been made in that area and a strong, concentrated effort will be required if sufficient progress is to be made in a timely fashion. In addition, the success of the City's remediation efforts will depend upon the City's leadership having the will to face up to the fiscal realities confronting the City and upon the several groups within the City government operating together to create a culture of compliance rather than one of convenience and disharmony that would impede moving the City forward to address its problems.

The City has begun the process to restore its credibility and create a model that other local governments can look to. It is important that this process move forward as rapidly as possible to achieve its objectives.

Respectfully submitted,

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March 25, 2008