



DATE ISSUED: March 26, 2007 REPORT NO: 07-082
ATTENTION: City Council Audit Committee
April 30, 2007
REPORT TO THE CITY COUNCIL
SUBJECT: Yellow Book Report, Fiscal Year 2003 CAFR
REFERENCE: FY 2003 CAFR

REQUESTED ACTION:

Receive and File

STAFF RECOMMENDATION:

As Above

SUMMARY:

The attached documents are the City of San Diego's, *Independent Auditors' 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* ("Yellow Book Report") and the KPMG SAS 61 letter for the fiscal year ending June 30, 2003.

The Yellow Book Report is the result of procedures performed pursuant to **generally accepted governmental auditing standards** ("GAGAS") which are for use by auditor's of government entities that receive government awards (state and federal grants). While it is not required to render an opinion as to the reasonableness of the City's Comprehensive Annual Financial Report; laws, regulations, contracts, grant agreements and other policies frequently require that audits be performed in accordance with GAGAS.

GAGAS are typically applied in conjunction with other auditing standards which govern attestation engagements for governmental entities (See AICPA standards). Though applied simultaneously, in the event of inconsistencies between GAGAS and standards promulgated by another standard setting body, the auditor should use GAGAS as the prevailing standard for conducting the engagement and issuing the Yellow Book Report. The reason for the application of GAGAS in conjunction with other procedures is stated in GAGAS paragraph 1.15(a) as follows:

"GAGAS describe ethical principles, and establish independence and other general standards, and additional field work and reporting standards beyond those provided by the AICPA for performing financial audits and attestation engagements."

Specifically, GAGAS require that the auditor report on the scope of the auditor's testing of compliance and internal control over financial reporting and presentation of the results of those tests. As such, the Yellow Book Report is an important document for consideration by the Audit Committee.

The Yellow Book Report details numerous findings concerning four broad areas of the City's internal controls and compliance with laws and regulations:

- Material Weaknesses in Internal Controls over the Financial Reporting Process,
- Violations of the Internal Revenue Code,
- Violations of the law related to the Wastewater System
- Violations of Securities Laws.

The majority of the weaknesses identified in the Yellow Book Report, have been well documented in previous reports to the City Council. Most notably, the January 2006 Annual Report on Internal Controls by the Auditor and Comptroller's Office provided a detailed analysis of many of the weaknesses identified in the KPMG Yellow Book Report. Additionally, many of these weaknesses were reiterated (along with the identification of new weaknesses) in the Report of the Audit Committee of the City of San Diego ("Kroll Report"). As part of the remediation efforts led by the Mayor's office, the City Council is receiving periodic reports on the status of various individual control weaknesses and their remediation.

While many of these control weaknesses have been, or are in the process of remediation, the City still continues to feel the effects of weaknesses in its system of internal controls. Perhaps the easiest way to quantify these effects is in the direct cost and time involved in producing financial statements worthy of an unqualified opinion from the City's external auditors. Past experience has shown that the costs associated with the City's annual audits have been more than 10 times that of what would be expected for a comparable entity with a strong system of internal controls. Specifically, the cost of the fiscal year 2003 audit (excluding special investigations) was approximately \$7 million dollars for the fiscal year 2003 audit. Comparatively, one would expect the cost for an annual audit of the City, if internal controls were strong, to approximate \$500 - \$700 thousand dollars annually. Aside from the direct costs of the audit, internal control weaknesses have many indirect costs associated with them, namely, the City has been forced to borrow at rates higher than necessary, experienced extensive litigation and claims costs and severe damage to the public's perception of the efficacy of the City's operations.

As the City Council considers the meaning of this report and develops conclusions, it is important to note that the process of establishing and improving internal controls is not one that can be achieved in a short time frame. The best internal controls are the result of careful consideration and a process that is inclusive of both operational constraints on implementing departments and those responsible for financial reporting and governance.

PREVIOUS COUNCIL and/or COMMITTEE ACTION:

2003 CAFR: April 23, 2007

2003 CAFR: October 16, 2006

Greg Levin, CPA
Auditor & Comptroller's Office

Jay M. Goldstone
Chief Financial Officer

ATTACHMENT 1 – Independent Auditors' 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.

ATTACHMENT 2 - Letters