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**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***

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

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of San Diego, California (City), as of and for the year ended June 30, 2003, which collectively comprise the City's basic financial statements and have issued our report thereon dated March 12, 2007 which includes an emphasis paragraph stating the net assets of the governmental activities, the business-type activities, the sewer utility, the water utility, the other enterprise funds, the internal service funds, the San Diego Convention Center Corporation, and the San Diego Housing Commission and the fund balances of the general fund, the other governmental funds, the pension and employee savings trust fund, and the investment trust fund have been restated as of June 30, 2002. Our report was modified to include a reference to other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Other auditors audited the financial statements of the San Diego Housing Commission, as described in our report on the City's financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the City's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the City's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying Attachment I as item 2003-1.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily



disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we consider item 2003-1 described above to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying Attachment I as items 2003-2, 2003-3 and 2003-4.

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

KPMG LLP

March 12, 2007

CITY OF SAN DIEGO

Schedule of Findings and Responses

June 30, 2003

Item 2003-1, Material Weakness in Internal Controls over the Financial Reporting Process

The City prepares annually a Comprehensive Annual Financial Report (CAFR) which includes its basic financial statements. We found that the City had inadequate policies, procedures, internal controls and personnel to ensure that an accurate and reliable CAFR was prepared and reviewed on a timely basis. Indicators of control deficiencies included our identification of material misstatements, the restatement of previously issued financial statements, the ineffective oversight of the City's financial reporting and internal control by those charged with governance, an ineffective control environment, inadequate controls over the selection and application of accounting principles, inadequate controls over nonroutine and nonsystematic transactions, and inadequate controls over the period-end financial reporting process. Due to these deficiencies, we proposed numerous material corrections to the CAFR as of and for the year ended June 30, 2003, and the reported June 30, 2002 net assets have been restated to correct for numerous items totaling over \$1 billion.

Specifically, deficiencies were noted in the following areas:

- CAFR Preparation
- Pension Accounting
- Capital Asset Accounting
- Metropolitan Wastewater Utility
- Risk Management
- City Treasurer's Cash and Investment Pool
- Procurement
- Accounts Payable and Accrued Expense
- Human Resources
- Accounts Receivable
- Information Technology

CAFR Preparation

In order to prepare the CAFR, a thorough understanding of U.S. generally accepted accounting principles, most notably Governmental Accounting Standards Board (GASB) Statement No. 34, is required. We noted the following errors due to deficiencies in internal controls over the CAFR preparation process:

- There was an incorrect classification and presentation of various funds within the CAFR. This included incorrectly reporting San Diego Data Processing Corporation as an enterprise fund, San Diego Medical Services Enterprise as a discretely presented component unit rather than a joint venture, the City's 401K Plan as an agency fund, and City resources set aside for repayment of tax anticipation notes as an agency fund. Additionally, the City incorrectly omitted an investment trust fund representing cash owned and interest earned by legally separate entities within the City Treasurer's investment pool and incorrectly reported the Centre City Development Corporation's defined contribution plan assets as a fiduciary fund even though such assets were not held by the City in a trustee or agency capacity.

- Various debt transactions were not properly recorded. For example, loan proceeds were recorded as revenue rather than as debt, e.g. SANDAG loan, certain debt and the related investments held with an escrow agent were not properly removed when such debt was defeased, bond issuance costs were incorrectly expensed instead of being deferred in accordance with GASB No. 34, accrued interest payable was incorrectly calculated at year-end, and an arbitrage liability was not recorded.
- The City did not properly recognize certain revenues when recognition criteria were met. Additionally, the City's calculation of deferred revenue in the fund statements incorrectly included notes receivable due from developers, one-time revenue received from the State, and working capital advances receivable.
- The City incorrectly included investments as part of cash and cash equivalents within the Statement of Cash Flows.
- Errors were made in recording various land held for resale parcel transactions and the City incorrectly reported land held for resale at cost instead of estimated net realizable value.
- Interfund transactions, e.g. purchases and sales of land, were not properly identified and recorded at the correct historical cost. Additionally, interfund transfers were incorrectly recorded as working capital advances.
- The accrual for compensated absences was not properly calculated at year-end and certain components (add-on pay and employer taxes) were incorrectly excluded from the calculation.
- PETCO Park leasehold improvements made by the San Diego Padres were incorrectly recorded by the City as contribution revenue. Additionally, the City's liability for the future conveyance of ballpark land parcels to the Padres was not recorded.
- Leasehold improvements on City owned property were incorrectly recorded as contribution revenue, e.g. Zoological Society of San Diego.
- Errors at component units (legally separate entities that are included in the City's CAFR) were repeated in the City's CAFR. For example, errors in the receivable for purchased service credits and the liability for DROP obligations (San Diego City Employees' Retirement System) and in recording an incentive payment received on a food and beverage contract (San Diego Convention Center Corporation) occurred within those entities and were not detected prior to being included in the City's CAFR.
- There was a lack of a formal process for management review and evaluation of the completeness and accuracy of financial statement note disclosures.

Pension Accounting

Statement No. 27 of the Governmental Accounting Standards Board, *Accounting for Pensions by State and Local Governmental Employers*, established standards for local government pension accounting. The statement requires the City to measure and disclose an amount for annual pension cost on the accrual basis of accounting, which starts with the calculation of an annual required contribution (ARC), based upon actuarial standards.

The City had a mechanism to set aside a portion of pension plan assets as "surplus earnings," also known as excess investment earnings. The "surplus earnings" were used to fund a variety of additional benefits for employees, such as retiree health benefits, or to "fund" employee offset payments, i.e. picking up the employee's

share of contributions. However, the City did not consider these activities when calculating pension expense in its financial statements.

A similar scenario was recently illustrated in a GASB implementation guide, a portion of which stated:

A defined benefit pension plan administers a postemployment healthcare plan that is funded by “excess investment earnings” (investment earnings for a particular year in excess of the long-term investment earnings assumption used for actuarial valuation purposes). Excess investment earnings are credited to a plan net assets reserve account within the pension trust fund, from which a portion of the total cost of healthcare insurance coverage for retirees is paid.

Although in form the healthcare benefits are provided by the plan, rather than the employer, in substance it is the employer that supports the benefits through higher contribution requirements. Actuarial valuations of the pension plan, from which the funded status of the plan and the ARC are derived, include as a key assumption a long-term investment earnings (discount rate) assumption. The calculations assume that actual earnings will exceed the assumption in some years and fall short of the assumption in other years. If, however, an amount equal to the excess earnings on pension trust fund assets in good years is applied to provide an additional postemployment benefit other than pensions, the employer’s contribution in relation to the ARC for that year should not be regarded, for accounting and financial reporting purposes, as supporting the pension benefits only. Rather, the employer is in the position of supporting, directly or indirectly, two benefits.

Correcting for additional benefits and other pension accounting issues resulted in increasing the June 30, 2002 net pension obligation in the City’s government-wide financial statements by \$90.4 million.

Additionally, certain benefits, i.e. Corbett, were not included in the actuarial accrued liability disclosure as they were inappropriately defined as being “contingent.” Correcting this issue increased the actuarial accrued liability disclosure by \$55.9 million as of June 30, 2002.

Capital Asset Accounting

We noted a number of errors in the City’s financial statements due to deficiencies in internal controls related to capital asset accounting. For example:

- Assets which had been placed in service were not transferred from construction-in-progress to depreciable assets which resulted in a misclassification of reported capital assets and an underreporting of depreciation expense.
- Various projects where certain planning, pre-design, and preliminary costs had been incurred but the projects were later canceled or abandoned were not removed from the City’s reported capital asset balances.
- During the implementation of GASB No. 34 in fiscal year 2002, the City was required to capitalize infrastructure assets for the first time. However, the City added certain assets during this process to its financial statements that were already recorded in its capital improvement program.
- Developer contributed assets were not being recorded as City assets, or were not being reported in the year in which the transactions occurred, which resulted in an understatement of capital assets in the City’s financial statements.

- Various errors in book values or estimated useful lives of assets resulted in an increase in net capital assets reported in the City's financial statements.
- Errors in recording various parcels of land resulted in an increase of capital assets in the City's financial statements.
- Errors in recording retentions payable and trust accounts related to capital activity occurred.
- There was a failure to capitalize interest as part of certain asset acquisition costs.

Metropolitan Wastewater Utility

Revenue received from the Metropolitan Wastewater Utility Participating Agencies was not reconciled to supporting information which resulted in a \$9.5 million overstatement of deferred revenue as of June 30, 2002. Additionally, Metropolitan Wastewater grants receivable were not reconciled to supporting information. Thus, errors occurring when subsequent grant receipts were reported as additional revenues were not detected.

Risk Management

In the normal course of business, the City is a defendant in various litigation. Such litigation is primarily related to general liability and workers' compensation claims but also may include other various types of cases. The City is self-insured for general liability and workers' compensation and has recorded a liability, based on results of actuarial studies performed by an independent actuary, in the City's internal service funds. In addition, the City may be required to establish an estimated liability (general litigation liability) for other litigation not covered under the self-insurance program. For the year ended June 30, 2003, we noted only limited communications between the Risk Management Office and the City Attorney's Office regarding outstanding case reserves and other litigation issues.

Additionally, the City incorrectly understated its workers compensation liability by \$64.9 million as of June 30, 2002 due to errors in its calculation methodology and incorrectly overstated its public liability claims by \$21.9 million as of June 30, 2002 due to the communication issues noted above.

City Treasurer's Cash and Investment Pool

The City's process for allocating interest and reconciling cash and investments was unduly cumbersome, lacked proper management review, and was not performed in a timely manner. During our procedures on cash and investments, we specifically noted the following:

- Although the City performed a three way reconciliation between the bank, the general ledger, and the Treasurer, the general ledger balance was difficult to determine.
- Only 33% of the accounts selected for test work were completed in a timely manner as defined to be 45 days by the City Treasurer's performance measures.
- Reconciling items remained outstanding for several months due to lack of communication between the Auditor & Comptroller's Office and the Treasurer's Office, and because reconciliations were not prepared in a timely manner.

- The interest allocation process did not go through management review and, consequently, errors were found in the allocation.

Procurement

During our review of the procurement functions, we noted the following deficiencies:

- Departments have the ability to procure non-engineering consulting services without the involvement of the Procurement Department. Additionally, there is no control in place to ensure that multiple services from the same consultant which exceed \$250,000 in the aggregate are approved by the City Council.
- We noted instances where the person who completed the manual receiving report for the receipt of goods could also be the same individual making the initial requisition.
- The City uses a PA2610 requisition form to purchase items from vendors when a blanket purchase order has been issued. However, we noted that there is no formal process to track the issuance of blank PA2610 forms. Once a purchase order has been issued, City employees in possession of the form could obtain goods and services directly from a vendor location, similar to a check.

Accounts Payable and Accrued Expense

We noted that to record the accounts payable accruals as of year end, the City kept a parallel period open from July 1, 2003 to August 15, 2003. During the parallel period, for all disbursements greater than \$100,000 that related to the fiscal year 2003, the City accrued the expenditure at year end. All disbursements made subsequent to August 15, 2003 were recorded in fiscal year 2004, regardless of which year the services were received. Additionally, errors were noted related to utility bills which were being recorded on the cash basis.

Human Resources

Upon the hiring of new employees, no review is performed to ensure that all pertinent documentation is included in the employee personnel file. We noted instances where employee files did not include all required and relevant employment documents.

Accounts Receivable

We noted a number of deficiencies in internal controls related to accounts receivable accounting. For example:

- Subsidiary ledgers and supporting detail listings for the City's various types of accounts receivable are not reconciled to the general ledger.
- Estimated year end accruals are not properly analyzed and supported.
- There is no formal analysis performed to determine the adequacy of the allowance for uncollectible accounts.
- Estimated year end water and wastewater accruals for earned but unbilled (EBUB) revenue are not properly calculated. The basis of the EBUB accrual calculation uses current year billed amounts. However, a portion of these billed amounts are subsequently adjusted and credited and rebilled (credit and rebills) after year end. This methodology results in an overstatement of the year end EBUB accrual.

Information Technology

Information technology at the City is antiquated and does not effectively support the CAFR preparation. Further, we found weaknesses in information technology related internal controls in the following areas:

- Lack of documented policies and procedures for information security
- Inadequate network and application password controls
- Inappropriate RACF (security software) administrator access
- Lack of formal process for adding/deleting users from critical systems
- Little control over the creation of unlimited vendor and contractor identifications
- Inappropriate user access of VOS (workers compensation claim system) applications in the Risk Management Department
- Lack of review of VOS exception reports in the Risk Management Department
- Inappropriate user access – FAMIS (fixed asset) application
- Lack of segregation of duties in the payroll/personnel departments
- Inappropriate system administrator access in the City Automated Personnel Payroll System (CAPPS)
- Inappropriate access to create vendors in OPIS (procurement system)
- Inappropriate access to modify user application security in the OPIS procurement system
- Inappropriate access to enter invoices in the accounts payable system
- Segregation of duties conflicts for procurement activities
- Inadequate application change control policies and procedures.

Recommendation

Although a number of changes in personnel and processes have been made from June 30, 2002 to the present, the City will need to continue to reorganize, improve and document its processes, and train its personnel in order to establish a system of internal control which can reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements would not be detected within a timely period by employees in the normal course of performing their assigned functions.

In addition, the City should implement the applicable remedial actions as outlined in the Mayor's August 24, 2006 responses to the Kroll Report.

Views of Responsible Officials

We agree. The City recognizes the need for an improved financial reporting control framework and as such, continues to construct a better financial reporting process. As part of this, the City has committed itself to implementing all applicable remediation actions outlined in the Kroll report. Most notably, the City has begun the procurement process for a new financial accounting system (Enterprise Resource Planning System), implementation of this system will result in overhauling the vast majority of the City's accounting practices.

Item 2003-2, Violations of the Internal Revenue Code

San Diego City Employees' Retirement System (SDCERS) operates as a retirement system trust fund under Section 401(a) of the Internal Revenue Code of 1986, as amended ("IRC"). As a plan qualified under Section 401(a), SDCERS receives tax exemption, pursuant to IRC Section 501(a), on monies accruing within the pension trust fund. The City may not have complied with the IRC in the manner in which it funds and administers healthcare benefits for employees. Between 1982 and 2005, the use of SDCERS Surplus Earnings to fund retiree healthcare benefits and the administration of the retirement healthcare program through SDCERS may have violated the qualification requirements of IRC Section 401(a) and IRC Section 401(h).

Recommendation

The City should implement the applicable remedial actions as outlined in the Mayor's August 24, 2006 responses to the Kroll Report.

Views of Responsible Officials

We agree. On June 22, 2006, Ice Miller LLP, SDCERS' tax consultant, filed a report titled "Exclusive Benefit and Prohibited Transactions - Retiree Medical Benefits (401(h) Account)" with the Internal Revenue Service (IRS). This report is one of the filings submitted on behalf of SDCERS in its participation in the IRS's Voluntary Compliance Program, supporting SDCERS' application to obtain a Tax Determination Letter as a qualified pension plan. SDCERS and the City expect to receive a final determination on this filing during the summer of 2007.

Several actions have already occurred to change the manner in which retiree healthcare benefits are funded. Effective July 1, 2003 (Fiscal Year 2004), the City ceased designating any portion of its Annual Required Contribution to a 401(h) account with SDCERS. In February 2005, after the remaining balance of the SDCERS 401(h) account was exhausted, the City began separately funding and paying its retiree healthcare benefit on a pay-as-you-go basis. Action is still pending with the City to amend the San Diego Municipal Code related to the definition and use of Surplus Earnings in the "waterfall".

In recognition of the upcoming reporting requirements imposed by GASB 43, the City is taking steps to create a long-term funding plan for a separate retiree healthcare trust that will use actuarially-determined rates.

Item 2003-3, Violations of Law: Wastewater

The Clean Water Act requires municipalities to structure their rates in a proportionate manner to ensure that each user pays his fair share. Although the Clean Water Act does not define proportionality, the State Water Resources Control Board, which promulgates regulations interpreting the Act, does, and it explicitly requires that certain measurements be included in the sewer rate structure. Because the City's rate structure for the ten-year period from 1995 to 2004 did not fairly allocate the significantly higher cost of treating wastewater discharged

by certain industrial users, resulting in residential users subsidizing the rates of industrial ones by millions of dollars per year, the City's rates were not proportionate and thus may have violated the Clean Water Act's proportionality requirement.

Similar to the Clean Water Act, Proposition 218 also contains a proportionality component, requiring that fees imposed upon "any parcel or person as an incident of property ownership shall not exceed the proportional cost of the service attributable to the parcel." Although the issue is not settled, there is authority suggesting that Proposition 218's proportionality requirement applies to sewer charges, and, if so, the City may have violated this requirement.

Recommendation

The City should implement the applicable remedial actions as outlined in the Mayor's August 24, 2006 responses to the Kroll Report.

Views of Responsible Officials

We agree. The City has implemented a rate structure that is consistent with the guidelines of the State Water Resources Control Board and Proposition 218 requirements. Furthermore, the City has entered into a tentative settlement agreement to end a class action lawsuit regarding the matter; this will require proposition 218 noticing before becoming final.

Item 2003-4, Violations of Securities Laws

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

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

- The City failed to disclose that the City's unfunded liability to its pension plan was projected to dramatically increase.
- The City failed to disclose that it had been intentionally under-funding its pension obligations so that it could increase pension benefits but defer the costs, and that it would face severe difficulty funding its future pension and retiree healthcare obligations unless new revenues were obtained, pension and healthcare benefits were reduced, or City services were reduced.
- The City knew or was reckless in not knowing that its disclosures were materially misleading.
- The City made these misleading statements through three different means:
 1. The City made misleading statements in the offering documents for five municipal offerings in 2002 and 2003 that raised over \$260 million from investors. The offering documents containing the misleading statements included the "official statements," which were intended to disclose material information to investors, and the "preliminary official statements," which were used to gauge investors' interest in a bond issuance.

2. The City made misleading statements to the agencies that gave the City its credit rating for its municipal bonds.
3. The City made misleading statements in its “continuing disclosure statements,” which described the City’s financial condition and were provided by the City to the municipal securities market with respect to prior City bond offerings.

The City consented to the issuance of the Order without admitting or denying the findings in the Order. The SEC’s investigation is ongoing as to individuals and other entities that may have violated the federal securities laws.

Recommendation

The City should implement the applicable remedial actions as outlined in the Mayor’s August 24, 2006 responses to the Kroll Report.

Views of Responsible Officials

We agree, as stated above the City has consented to the SEC order, and as part of the applicable remediation, the City has already retained an independent monitor to oversee the City’s compliance with and remediation of the issues identified in the Order.