



KPMG LLP
55 Second Street
San Francisco, CA 94105

March 23, 2007

Audit Committee
City of San Diego
San Diego, California

Ladies and Gentlemen:

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. Under our professional standards, we are providing you with the attached information related to the conduct of our audit.

Our Responsibility under Professional Standards

We have a responsibility to conduct our audit of the financial statements in accordance with professional standards. In carrying out this responsibility, we planned and performed the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, we are to obtain reasonable, not absolute, assurance that material misstatements are detected. We have no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are not material to the financial statements are detected.

In addition, in planning and performing our audit of the financial statements, we considered internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

Accounting Policies

Significant Accounting Policies

The significant accounting policies used by the City are described in note 1 to the financial statements.

Unusual Transactions

We have an obligation under professional standards to inform the audit committee about the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. Following is a summary of such transactions.

- On February 1, 2000, the City entered into a Joint Use and Management Agreement (Agreement) with the San Diego Padres baseball team (Padres) governing the rights and duties of the City and the Padres with respect to the use and operation of the new Petco Park Ballpark Facility (Facility). The Facility



was completed and operational in April 2004. The City and the Padres jointly own the facility. The Padres have a 30% divided interest based upon the original facility cost estimate of \$267.5 million (or \$80.25 million), with the City owning the balance. The portion of the Facility funded by the Padres has been excluded from the capital assets and net assets of the City.

- The Zoological Society of San Diego leases Balboa Park from the City and routinely constructs capital assets on the City's land. These capital assets have been excluded from capital assets and net assets of the City.
- The City, as part of approving new development in the community planning process, requires that certain public facilities be constructed per the provisions of community financing plans. Historically, the City has agreed to pay a pro rata share of these assets. In lieu of providing direct funding for said assets, the City often provides developers with credits for future permit fees. These credits are earned by the developer upon successful completion of construction phases and when City engineers have accepted the work. The credits are recognized as permit revenue upon issuance and a corresponding capital asset is recorded in the governmentwide financial statements.
- The City provides certain healthcare insurance benefits to certain retired employees. Amounts were transferred from annual realized earnings of San Diego Employees' Retirement System's (SDCERS') pension assets to an employer contribution reserve for the purpose of funding the retiree health benefits that would have otherwise been paid by the City. Such healthcare insurance benefits paid to retired employees have been added to the City's net pension obligation.
- In 1998 a lawsuit was filed by retired employees who alleged that the City's method of calculating retiree pension benefits improperly excluded the value of certain benefits such as vacation and sick leave when computing the employees' pensionable salaries. The City settled in May of 2000, known as the Corbett Settlement. This settlement provided for a flat increase of 7% in benefits payable to eligible retirees from annual realized earnings of SDCERS pension assets, if sufficient. To the extent earnings are insufficient; the unpaid amount is carried forward. These benefits have been included as part of the unfunded accrued actuarial liability (UAAL) and annual required contribution (ARC) in the City's Comprehensive Annual Financial Report (CAFR).
- The City has a Deferred Retirement Option Program (DROP). If a SDCERS member participates in DROP, they are entitled to receive a lump-sum benefit or periodic distributions in addition to their normal monthly retirement allowance when they leave employment with the City. A DROP participant continues to work for the City and receives a regular paycheck. The DROP participant makes reduced retirement contributions to SDCERS and the DROP participant stops earning creditable service. DROP obligations have been shown as liabilities of SDCERS in the City's financial statements.
- The City of San Diego Purchase of Service Credit program allows a SDCERS member to purchase additional service credit for certain periods of time when the member did not contribute to SDCERS. The purchased service credits were priced such that the cost of the purchase was often less than the value received by the SDCERS member. The impact of the sale of such credits is not immediately recognized by the City but will increase the annual pension cost to the City over the long term.



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Management Judgments and Accounting Estimates

The preparation of the financial statements requires management of the City to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period.

Management's estimate of the self insurance liabilities (public liability, workers' compensation & long-term disability) is based on an analysis of historical trends and current claim information. We evaluated the key factors and assumptions used to develop the estimate of the self insurance liabilities in determining that the self insurance liabilities are reasonable in relation to the financial statements taken as a whole.

Management's estimate of the allowance for doubtful accounts is based on an analysis of past due accounts and includes the City's historical experience with the account type and other relevant factors to arrive at an overall assessment of whether accounts will be collected. We evaluated management's analysis of past due amounts and determined that it was reasonable in relation to the financial statements taken as a whole.

Audit Adjustments and Uncorrected Misstatements

Audit Adjustments

The City prepares annually a 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.

Such adjustments may impact the periodic reporting of the financial reporting system.

Uncorrected Misstatements

In connection with our audit of the City's financial statements, we have not identified any significant financial statement misstatements that have not been corrected in the City's books and records as of and for the year ended June 30, 2003 and have communicated that finding to management.

Other Information in Documents Containing Audited Financial Statements

Our responsibility for other information in documents containing the City's financial statements and our auditors' report thereon does not extend beyond the financial information identified in our auditors' report, and we have no obligation to perform any procedures to corroborate other information contained in these documents. We have, however, read the other information included in the City's CAFR, and no matters came to our attention that cause us to believe that such information, or its manner of presentation, is



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materially inconsistent with the information, or manner of its presentation, appearing in the financial statements.

Difficulties Encountered in Performing the Audit

We have an obligation under professional standards to inform the audit committee about any serious difficulties encountered in dealing with management related to the performance of the audit. The professional standards provide that “serious difficulties” to be reported may include, among other things, (1) “unreasonable delays by management in permitting the commencement of the audit or in providing needed information;” (2) “the timetable set by management was unreasonable under the circumstances;” and (3) “the unavailability of client personnel and the failure of client personnel to complete client-prepared schedules on a timely basis.” See AU § 380.16. We believe the following items are reportable to the Audit Committee consistent with this guidance:

- KPMG was retained to commence the audit in April 2004, or nine months after the end of the 2003 fiscal year.
- As shared in several meetings and correspondence with the City, including our attached letters, we do not believe that the City of San Diego initially conducted an adequate investigation into potential illegal acts and there was substantial delay in the completion of an adequate investigation due to a variety of actions and positions taken by City management. Such an investigation was necessary in order for KPMG, as the City’s auditor, to complete its audit in accordance with generally accepted auditing standards and *Government Auditing Standards*. Ultimately, an appropriate investigation was not completed until August 8, 2006. The delay was attributable to a number of factors which we believe are described in the attached correspondence.
- There were significant delays in management providing required information. Information supporting amounts reported in the CAFR was often incorrect, and had to be corrected by management several times. Audit procedures needed to be applied each time we received the updated information.
- Seventeen key drafts of the CAFR were prepared, including six since the December 1, 2006 version. We reviewed each draft, performed related audit procedures, and agreed selected information to supporting documentation each time an updated CAFR was received.
- Another significant difficulty encountered in the audit is attributable to the material weakness in internal controls over the financial reporting process. As we have reported to you, 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. We determined that the following material weakness in internal controls over the financial reporting process existed and caused serious difficulties related to the performance of the audit.

The City prepares annually a 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 governmentwide 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 nonengineering 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 the thirteenth period open from July 1, 2003 to August 15, 2003. During the thirteenth 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



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- 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.

Material Written Communications

Attached to this report are copies of the following material written communications between management and us:

1. Communications dated:

- August 9, 2004
- September 1, 2004
- October 11, 2004
- October 27, 2004
- October 29, 2004
- February 3, 2005
- April 29, 2005
- August 5, 2005
- September 22, 2005
- December 1, 2006

2. Management representation letters:

- City Management
- San Diego Employees' Retirement System Management

3. 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*



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This report to the audit committee is intended solely for the information and use of the audit committee and management and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

KPMG LLP



KPMG LLP
Three Embarcadero Center
San Francisco, CA 94111

Telephone 415 951 0100

August 9, 2004

Mr. Leslie J. Girard
Assistant City Attorney
Office of the City Attorney
City of San Diego
1200 Third Avenue, Suite 1620
San Diego, CA 92101

Re: Investigation

Dear Mr. Girard:

To date, we have had several discussions with Paul Maco of Vinson & Elkins (V&E) and have read the material provided by V&E with reference to their investigation and the formal inquiry and investigation being conducted by the Securities and Exchange Commission (SEC), the Department of Justice and US Attorney Office. Based on these discussions and our reading of the documents provided, we understand the following:

1. In September 2003, Ms. Diann Shipione, a San Diego City Employees' Retirement System (SDCERS) Board Member and Trustee, notified city officials and underwriters of errors and omissions in the City's financial statements dating back to 1996 and asserted the errors falsely improved the City's financial condition and were done intentionally to misstate and hide the real condition of the pension system.
2. Subsequent to the notification by Ms. Shipione, the City retracted the Preliminary Official Statement relating to a \$505 million bond offering, filed a voluntary disclosure statement with the SEC acknowledging errors and omissions and engaged V&E to investigate and issue a report on the disclosure practices of the City.
3. The city has sold more than \$2.3 billion in municipal bonds using financial statements believed to contain certain errors or omissions.
4. Ms. Shipione has alleged in various communications with the City Council, Mayor and other top city officials, that the steps taken to deliberately underfund the plan are illegal, violate the City Charter, and are at odds with statutes and court cases of the State of California.
5. Ms. Shipione has alleged that the decision to allow the underfunding was reached through a corrupt process in which the required funding was deferred to garner benefits for current employees.





Mr. Leslie J. Girard
Assistant City Attorney
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6. On June 11, 2004, the City reached a tentative settlement on the Gleason lawsuit. The Gleason lawsuit alleged that the underfunding of the pension plan was illegal and violated the City Charter, Municipal Code and California Constitution and that the SDCERS Board breached their fiduciary duties by allowing the City to underfund the plan. The settlement was reached without resolving the legal questions raised.
7. The SEC launched a formal inquiry in February 2004 under the anti-fraud provisions of section 17(a) 2&3 of the Securities Act of 1933 with reference the City's previous bond offerings. As part of that inquiry, we understand that the SEC may be considering allegations made in the press, and in particular allegations made by Ms. Shipione.
8. An e-mail provided to the SEC appears to indicate the SDCERS actuary may have worked with the City to change assumptions with the intent of lowering the calculated actuarial required contribution by the City.

AICPA Professional Standards state in section AU 317:

.10 When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor should inquire of management at a level above those involved, if possible. If management does not provide satisfactory information that there has been no illegal act, the auditor should—

- a. Consult with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. Arrangements for such consultation with client's legal counsel should be made by the client.
- b. Apply additional procedures, if necessary, to obtain further understanding of the nature of the acts.

As indicated in our engagement letter dated April 13, 2004, we will not issue our auditors' report until a determination is made that the investigation being conducted by V&E is sufficient and complete. We acknowledge V&E's effort and cooperation in explaining the process they are undertaking to KPMG.

Based on discussions with you, V&E, and the reading of the documents provided and, consistent with our previous conversations, we are providing you the following



Mr. Leslie J. Girard
Assistant City Attorney
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observations regarding our understanding of the scope of the investigation to help avoid surprises once we review the draft report.

We believe the investigation being conducted by V&E should address and resolve the following questions:

1. Whether or not the financial statements and or the disclosures in the financial statements were intentionally misleading and, if yes, what individuals were involved and what, if any, remedial action is recommended?
2. Did the City enter into any agreement, including the “Managers Two” agreement, or otherwise take any actions that resulted in the underfunding or misuse of pension funds that is a violation of State, City or other laws?
3. Did the SDCERS Board breach their fiduciary duty by allowing the City to underfund the plan in exchange for additional benefits for current employees and could this action have been in violation of any laws?
4. Is the use of surplus earnings to pay city obligations such as benefits outside of the plan illegal?
5. Did the City violate the City Charter by failing to fund its retirement plan as required by the City Charter?
6. Did the SDCERS Board and/or the City violate the California Constitution by allowing the City to intentionally underfund the plan?
7. Was undue influence placed on the actuary to change assumptions to reduce the shortfall of the City’s contribution compared to the ARC, and, if yes, at whose direction and what action does the City plan to take to rectify this action, if applicable?

It is our understanding that the electronic evidence gathered by the investigation has been limited to documents identified by City employees in response to a SEC subpoena. In order to adequately address the allegations raised, we believe the investigation should consider conducting independent electronic discovery.

As the investigation progresses and we are provided access to information as outlined in our engagement letter, we may request that the investigation consider additional items.



Mr. Leslie J. Girard
Assistant City Attorney
Office of the City Attorney
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We respectfully request your written response to these questions regarding the investigation.

Very truly yours,

KPMG LLP

A handwritten signature in black ink that reads "Steven G. DeVetter". The signature is written in a cursive, flowing style.

Steven G. DeVetter
Partner



KPMG LLP
Three Embarcadero Center
San Francisco, CA 94111

Telephone 415 951 0100

September 1, 2004

Leslie J. Girard, Esq.
Assistant City Attorney
Office of the City Attorney
City of San Diego
1200 Third Avenue, Suite 1620
San Diego, CA 92101

Re: Follow-up from meeting on August 27, 2004

Dear Mr. Girard:

We write to follow-up on our meeting on Friday in San Diego. We appreciate the opportunity afforded by that meeting to hear from the Vinson & Elkins ("V&E") representatives a status report on their investigation and to discuss with them and with you our respective views on the scope of the investigation as well as how its results will be shared with us.

On several occasions over the last few months we have had discussions about the investigation and we think it is fair to say that over that period we have expressed concerns about the scope of the investigation as it has been described to us. We expressed some of those concerns in our August 9, 2004 letter. While we remain concerned that the scope of the investigation may not be sufficient to enable us to conclude that the City has adequately addressed certain issues pertinent to our audits of the City's financial statements, we are prepared to proceed as outlined in our meeting by continuing to review the additional information being provided to us while we await the opportunity to review the final report.

Based upon our discussion on Friday, we understand that a number of the concerns raised in our August 9, 2004 letter may be addressed to some extent in the V&E report. However, you and V&E made it clear that V&E was retained only to investigate the City's disclosure practices and that, while there may be factual information pertinent to our broader concerns discussed in the report, we should not anticipate that all of the questions identified in our August 9, 2004 letter to you will be answered by the report. We will work diligently to review the information provided to us, determine whether such information is sufficient for our purposes and discuss our conclusions with you. We also appreciate your assurances that we will have access to V&E to discuss their report and the investigation; that the City will respond fully to any questions KPMG may pose that may not be addressed in the V&E report; and that the City is not imposing any deadline on KPMG to complete its work.

However, without in any way prejudging what our reaction to the final report will be, you should be aware that, if following our review of the V&E report we conclude that the V&E report is not sufficient to resolve all of the issues we face in the audit, we may advise you that additional investigative procedures may be necessary before KPMG can complete its work. In certain circumstances, we, as auditors may be obligated





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to raise any unresolved questions with the City Council which, according to our engagement letter, is the body to which our audit report is to be addressed. In addition, KPMG reserves the right to resign this engagement if it concludes, in its professional judgment, that the City's investigation of these issues has not been sufficiently comprehensive to enable KPMG to reach conclusions necessary for the issuance of an audit report.

In light of the issues currently facing us and to ensure that KPMG's position is clear to all concerned, we believe it is appropriate that we provide a copy of this letter to Lamont Ewell, City Manager, and Terri Webster, Acting City Auditor and Comptroller.

Thank you again for your time on Friday. Please contact us at your convenience to discuss any of the foregoing issues in greater detail.

Very truly yours,

KPMG LLP

A handwritten signature in black ink that reads "Steven G. DeVetter". The signature is written in a cursive, flowing style.

Steven G. DeVetter
Partner

cc: Mr. P. Lamont Ewell, City Manager
Ms. Terri Webster, Acting City Auditor and Comptroller



KPMG LLP
Three Embarcadero Center
San Francisco, CA 94111

Telephone 415 951 0100

October 11, 2004

Leslie J. Girard, Esq.
Assistant City Attorney
Office of the City Attorney
City of San Diego
1200 Third Avenue, Suite 1620
San Diego, CA 92101

RE: CITY OF SAN DIEGO FISCAL YEAR 2003 AUDIT

Dear Mr. Girard:

As shared in previous meetings and correspondence, including our letters dated August 9, 2004 and September 1, 2004, we do not believe that the City of San Diego ("City") has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred, or that appropriate remedial action has been taken. Such an investigation is necessary in order for an auditor to complete an audit in accordance with generally accepted auditing standards and *Government Auditing Standards*.

The primary purpose of this letter is to express KPMG's position on what additional action KPMG believes the City should take relating to the investigation and remediation of potential illegal acts to enable KPMG to complete its audit of the City's basic and fund financial statements for the fiscal year ended June 30, 2003. KPMG has been concerned that the City was not undertaking an investigation specifically designed for the purpose of addressing audit responsibilities under generally accepted auditing standards and *Government Auditing Standards* relating to possible illegal acts. At the City's request, and as reflected in our September 1, 2004 letter, KPMG agreed to await the completion of the Vinson & Elkins ("V&E") report (the "Report"), to review the Report, and to advise the City as to what, if any, further information KPMG required in order to be in a position to complete its audit and issue its audit reports. As discussed, and as explained in more detail below, our overriding concern has been and remains, that an investigation must be of sufficient scope and thoroughness to provide a sound basis for concluding either that illegal acts with relevance to the City's financial reporting have not occurred or that appropriate remedial action has been taken with respect to any conduct which the City and its counsel cannot definitively conclude was legal.

At your request and to make our next meeting as constructive as possible, we have attempted in this letter to synthesize what additional action we believe the City needs to take to enable KPMG to complete its audit, and also to explain in general terms why this additional action is necessary.



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Mr. Leslie J. Girard
Assistant City Attorney
Office of the City Attorney
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BACKGROUND

We understand that the SEC is conducting a formal investigation of the City of San Diego's public disclosures relating to the SDCERS in the City's bond offerings during the period 1996 through January 2004. This investigation was commenced following the City's filing of a Voluntary Report of Information on January 27, 2004 with the Municipal Securities Rulemaking Board and the Nationally Recognized Municipal Securities Information Repositories. That Voluntary Report made new disclosures regarding the City's obligations to fund the SDCERS and also disclosed that there had been errors in the City's 2002 CAFR.

We also understand that the U.S. Attorney and FBI are conducting a criminal investigation relating to the City's pension funding and disclosures. There have also been press reports of an additional investigation by the FBI relating to possible "public corruption" issues relating to the process by which the City and SDCERS have negotiated and approved various agreements in which the City's obligations to make payments to fund SDCERS were reduced and/or deferred in exchange for agreements to increase or expand benefits.

We understand that all of these investigations are focused on the conduct of individuals who either are currently employed by the City, were employed by the City during the period covered by KPMG's ongoing audit, or were acting in some manner on behalf of the City or SDCERS during the relevant time period.¹

V&E was retained by the City and conducted an investigation into the City's disclosure practices and prepared a report. The V&E Report, which was made public on September 16, 2004, describes systemic failures in the City's financial reporting and disclosure processes related to the SDCERS pension plan. See e.g., Report at 170-171 (referring to "across the board failures of the City's internal disclosure processes.") It also reflects that, as late as the fall of 2003 the City's Disclosure Counsel thought information was being withheld from him and there were fundamental disagreements about whether acknowledged errors in the historical financial statements were material. Report at 114-120. The Report acknowledges that the City's prior SDCERS related disclosures were inadequate, and while it appears to stop short of concluding that there were material misstatements in the City's disclosures, it describes a dysfunctional disclosure system and also comments upon the City's "minimalist approach to public disclosure." Among the observations supporting this conclusion is the statement that "the City Auditor was disinclined to

¹ Potential illegal acts by SDCERS or its board are relevant to KPMG's audit. Your position (expressed in the September 20, 2004 letter), that SDCERS is an "entity independent of the City," does not address the fact that the financial condition of SDCERS is reported as a fiduciary fund in the City's CAFR.



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include information in the City disclosure that reflected badly on the City and would sometimes excise negative statements from disclosure documents.” Report at 117.

The V&E report includes two paragraphs under a heading “Conclusions Regarding Intent.” Report at 164. These paragraphs state that because many of the “gaps” in the City’s disclosures are “closed” when information in the SDCERS CAFRs is considered and because local press coverage of the pension plan highlighted many of the risks surrounding the more controversial City funding agreements (Managers 1 and 2) and the presence in the Municipal Code of the menu for distribution of surplus earnings, any attempt to conceal the SDCERS funding situation would have been an “exercise in futility.”

While we understand that V&E has concluded that it has gathered sufficient evidence to support this conclusion, for purposes of our audit, we note that this conclusion does not address the questions we have posed as being important to our completion of our audit, and therefore, does not end our inquiry. Indeed at our meeting on August 27, 2004, Both the City and V&E have made it clear to KPMG that V&E was not retained to investigate issues relating to intent or whether any individual’s conduct violated any law, rule or regulation, and that the scope of its investigative efforts were not designed to do so. At that meeting, we informed the City that, in the absence of conclusions on such issues, KPMG anticipated advising the City that additional investigative procedures may be necessary before KPMG would be in a position to complete its audit; and, in turn, we were advised that the City would perform any additional inquiries that KPMG believe were necessary for it to be able to conclude on issues that might affect its ability to issue an audit opinion.

Unfortunately, based upon the information we have been provided to date regarding the scope and method of the V&E investigation, we do not believe the statement in the report that “it is difficult to attribute the City’s failure to fully and accurately describe [pension] matter[s] to intentional misconduct on the part of individual employees” is sufficient to resolve the issue of potential illegal acts for purposes of KPMG’s audit because it is not based on an investigation that had a scope and methodology that would provide a reliable basis for reaching a conclusion as to whether City officials engaged in intentional misconduct or other conduct, which violated any law, rule or regulation having the force of law.

It is in this context and against these background facts, that KPMG’s requirements, as outlined in this letter, must be understood. Most fundamentally, because there is evidence of possible illegal acts by the City or persons whose acts are attributed to it, under Generally Accepted Auditing Standards (GAAS) and Generally Accepted *Government Auditing Standards* (GAGAS), as well as other relevant professional guidance, to the extent the following questions are not directly



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Assistant City Attorney
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addressed in the V&E Report, additional investigative procedures are required in order to determine if illegal acts are likely to have occurred, to assess the direct or indirect effect of such acts on the City's financial statements as well as the implications for the reliability of representations being made by City employees to KPMG in the course of our audit, and to determine if any such illegal acts have been adequately remediated by the City.

The report based on such an investigation must include clear conclusions and be supported by a thorough investigation. However, as stated above, and as KPMG has been advised, the V&E investigation was not conducted as a forensic investigation, and did not result in a report that reached clear conclusions about whether federal securities laws (or any other relevant laws) had been violated, did not explore potential individual conduct that may be fraudulent or unlawful, and thus does not provide a basis for determining potential financial statement effects or determining KPMG's ability to rely on management representations from the City.

Further, the Report's discussion of certain evidence raises a concern that the investigation, for our purposes, did not adequately follow up on evidence which might suggest that certain of the deficiencies in financial reporting may have been the result of conscious efforts by one or more persons at the City. In the absence of an investigation and report that adequately explores these issues, it is not possible to determine if the City has taken appropriate remedial measures or if the representations made to us during our audit by certain individuals can be relied upon by us in reaching our opinion on the financial statements.²

In this regard it also bears noting that the remedial measures recommended in the Report are all prospective and entail structural reforms to address the City's process of disclosure in the future. These reforms are subject to approval by the City Council and, even if adopted, would have no impact on the manner in which the City will have prepared its 2003 audited financial statements.

² See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions Exchange Act Release No. 44969, 2001 SEC LEXIS 2210 (Oct. 23, 2001), arising out of an investigation into financial reporting by Seaboard Corporation.



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Assistant City Attorney
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OVERVIEW OF RELEVANT AUDITING AND ACCOUNTING REQUIREMENTS

AICPA State and Local Audit and Accounting Guide § 4.44.

(1) Illegal Acts with Direct and Material Effects on Financial Statement Amounts

GAAS requires an auditor to plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatements arising from illegal acts that have a direct and material effect on the determination of financial statement amounts. The auditor's consideration of those potential misstatements is a matter of professional judgment and is influenced by his or her perceptions of the needs of a reasonable person who will rely on the financial statements.

The professional literature identifies the following types of legal compliance requirements as among those that may have a "direct and material" effect on the determination of financial statement amounts.

- **GAAP Requirements.** Governments often are subject to legal or contractual provisions that require them to prepare their financial statements in conformity with GAAP.
- **Federal and State Taxes.** Governments are subject to various federal tax requirements, including those relating to employment taxes, employee benefits, and tax-exempt debt (such as arbitrage rebate requirements). State-level tax requirements also may apply.

(2) Illegal Acts With Indirect Effects on Financial Statements

The auditing literature also recognizes that Governments often are affected by many other laws or regulations, which generally relate more to an entity's operating aspects than to its financial and accounting aspects, and that the financial statement effect of those laws and regulations is "indirect". Although an auditor is not required to plan the audit to detect noncompliance with such laws and regulations, the auditor does have certain detection, consideration, and reporting responsibilities relating to potential violations of such laws, which require the auditor to insist that when potential violations of such laws come to light, they must be investigated.

Moreover, GAAP requires a government entity, such as the City, to disclose in its financial statements material violations of finance-related legal and contractual provisions. Accordingly, the



Mr. Leslie J. Girard
Assistant City Attorney
Office of the City Attorney
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auditor of a governmental entity is alert to the possible financial reporting effect of noncompliance with law that has a material indirect effect on financial statements. Because the government entity itself has financial statement reporting obligations related to violations of such laws, the government and the auditor both have a shared interest in assuring that when potential violations of such laws come to light, they are fully investigated so that the financial statements can include the GAAP³ required disclosure.

In considering whether the financial statements are free of material misstatements arising from (1) illegal acts that have a direct and material effect on the determination of financial statement amounts, or (2) illegal acts that have an indirect material effect on financial statements, the auditor should consider both quantitative and qualitative factors. Qualitative factors that the auditor may consider relevant to that evaluation include the following:

- The potential effect of the noncompliance on the government's ability to raise resources (for example, through taxes, grants, contributions, or debt or loan financings) in the future.
- The potential effect of the noncompliance on the continuation of existing relationships with vendors, employees, and elected and appointed officials.
- Whether the noncompliance involves collusion or concealment.
- Whether the noncompliance involves an activity that often is scrutinized by elected or appointed officials, citizens, the press, creditors, or rating agencies.
- Whether the fact of the noncompliance is unambiguous rather than a matter of judgment.
- Whether the noncompliance is an isolated event or instead has occurred with some frequency.

³ GASB standards require governments to disclose certain violations of compliance requirements. NCGA Interpretation 6, Notes to the Financial Statements Disclosure, paragraph 4, states that the notes to the financial statements should disclose material violations of finance-related legal and contractual provisions. In addition, material violations, or potential violations, of finance-related legal and contractual provisions should be considered for recording a loss contingency. Id. at § 4.48.



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- Whether the noncompliance results from management's continued unwillingness to correct internal control weaknesses.
- The likelihood that similar noncompliance will continue in the future.
- The cost-benefit of establishing internal control to prevent similar noncompliance in the future.

The risk that possible undetected noncompliance would affect the auditor's evaluation.⁴

Finally, an auditor is required by applicable auditing standards to "consider the implications of an illegal act in a relation to other aspects of the audit, particularly the reliability of representations of management." AU § 317.16. In considering such issues, the auditor must be provided with sufficient information relating to the potential illegal acts to exercise professional judgment concerning the implications of a particular illegal act for the audit. *Id.* ("The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures and the level of management or employees involved.") Our April 13, 2004 engagement letter allows KPMG to make such a determination as to the sufficiency of the investigation for audit purposes.

INFORMATION AND REOCRDS REQUESTED, NOT YET PROVIDED

There are several open items which have been promised, but not yet provided to KPMG.

- KPMG has yet to receive all V&E interview notes, memoranda and supporting documents as requested. The basis for this request is outlined in our engagement letter.
- KPMG needs information concerning the scope and status of the criminal investigation(s), which we understand V&E is not handling. We will need to speak with the attorney representing the City in those matters.

ITEMS REQUIRING RESOLUTION BY THE CITY

Based on our review of the V&E investigation and Report, and in light of the auditing standards discussed above, KPMG has attempted to synthesize the issues that remain, which must be

⁴ *Id.* at § 4.46



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Assistant City Attorney
Office of the City Attorney
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resolved before we are able to complete our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*. They are as follows:

- The City needs to determine whether the City's public disclosures, including its financial statements, likely violate the antifraud provisions of the securities laws (e.g., failure to disclose pension related matters) or any other Federal, State or local laws, and if so, what, if any, impact is there to the June 30, 2003 financial statement amounts and disclosures? The report from the investigation team should include clear conclusions (with adequate support for such conclusions) whether an illegal act has occurred and whether such illegal act has been timely and adequately remediated. The report and investigation must be in sufficient scope and detail to allow us to reach our own conclusions as to (i) whether it is likely that an illegal act has occurred and, if so (ii) whether any likely illegal act that is identified will have a material effect on the entity's financial statements and, if so (iii) whether timely and appropriate remedial action has been taken. Closely related to this set of issues is whether City employees or agents have engaged in fraudulent actions including concealment, related to the potential illegal acts. The City needs to investigate and determine, and report to us, the relationship of the perpetration and concealment, if any, of likely illegal acts to specific control objectives and the level of management, employees, or consultants involved.
- The scope of the investigation needs to extend to all possible illegal acts and needs to expand, as necessary, based on findings made during the investigation. In other words, the investigators should be able to pursue all evidence of possible illegal acts no matter where they may lead.
- According to the Report, retiree healthcare benefits were paid directly out of the pension system from 1983 until 1992 when a determination was made that this violated federal tax regulations. A new system was set up which was also determined to be legally flawed in 1995, which was addressed by making payments a SDCERS benefit. While the Report compiles facts relating to this violation, and concludes that the funding method was violative of federal regulations, it does not address the possible consequences of this violation. What has the city done to consider and address the financial statement impact of possible IRS sanctions, or other contingent liabilities or disclosure obligations arising from the conduct that could impact the June 30, 2003 financial statement amounts and disclosures?



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- The issues from our August 9, 2004 letter must be addressed (see discussion in Exhibit I)

We look forward to meeting with the City to discuss further how the City can conduct an adequate investigation in order to conclude whether it is likely or not illegal acts have occurred, or that appropriate remedial action has been taken.

Very truly yours,

KPMG LLP

A handwritten signature in black ink that reads "Steven G. DeVetter". The signature is written in a cursive, flowing style.

Steven G. DeVetter
Partner

cc: Mr. Dick Murphy, Mayor
Mr. P. Lamont Ewell, City Manager
Ms. Terri Webster, Acting City Auditor and Comptroller

Exhibit I
Specific Comments Regarding September 20, 2004 City Response to KPMG's August 9, 2004 Letter

Attachments:
April 13, 2004 Engagement Letter
August 9, 2004 Letter from KPMG Re: Investigation
September 1, 2004 Letter from KPMG Re: Follow-up from meeting on August 27, 2004
September 20, 2004 letter from Les Girard Re: City of San Diego Fiscal Year 2003 Audit



SPECIFIC COMMENTS REGARDING SEPTEMBER 20, 2004
CITY RESPONSE TO KPMG'S AUGUST 9, 2004 LETTER

In your letter, you conclude by stating your view that the V&E Report "is sufficiently comprehensive to allow [KPMG] to reach the conclusions necessary for compliance with Section AU§317 of the AICPA Professional Standards and for the issuance of [KPMG's] audit report." For reasons previously articulated and expanded upon below, we are unable to agree with that conclusion.

As in many aspects of auditing, the conclusions involved in determining that potential illegal acts have been adequately investigated and remediated is one that entails an auditor's exercise of judgment. However, in the instant case, we believe that the issue is sufficiently clear that an informed and diligent auditor should not conclude that the V&E report adequately addresses the issues necessary for the completion of KPMG's audit. The Report may satisfy the City's needs (a conclusion we defer to the City to make); but, without more, it does not provide a sufficient basis for KPMG to conclude that all questions necessary to the completion of the audit have been sufficiently investigated and resolved in a manner that would permit KPMG to issue an audit report.

In response to your letter, we offer the following comments.

KPMG's Question 1

Whether or not the financial statements and or the disclosures in the financial statements were intentionally misleading and, if yes, what individuals were involved and what, if any, remedial action is recommended?

City's Comment on Question 1

Your comment seems to make two essential points. First, that with the departure of the City's prior independent auditor and the departure of the City Auditor and Comptroller, there is no need for an investigation into whether there were any intentional illegal acts relating to the City's underfunding of the SDCERS pension plan and/or financial reporting related thereto. Secondly, your comment seems to imply that the comments in the V&E Report at page 159 concerning the possible intent of City officials to allow the City to issue misleading financial disclosures should be sufficient for KPMG in the absence of KPMG's ability to cite you to investigative reports for municipal issuers or other issuers that address the issue of intent in a manner that goes beyond the V&E Report.

Response to City's Comment on Question 1

The subsequent departure of Mr. Ryan does not change the fact that, for the entire period KPMG is auditing, he was ultimately responsible for supervising the preparation of the City's financial



statements. Moreover, numerous individuals were (and remain) involved in the financial reporting process at the City, including individuals who, according to the Report, may have been involved in the disclosure deficiencies criticized by the Report.

Under AU 317.16: “The auditor should consider the implications of an illegal act in relation to other aspects of the audit, particularly the reliability of representations of management. The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures and the level of management or employees involved.”

Both the City and V&E have made it clear to KPMG that V&E was not retained to investigate issues relating to intent and that the scope of its investigative efforts were not designed to do so. Based upon what we have been told about the investigation, we do not believe the statement in the report that “it is difficult to attribute the City’s failure to fully and accurately describe [pension] matter[s] to intentional misconduct on the part of individual employees” is one that can be relied upon to resolve the issue of potential illegal acts for purposes of KPMG’s audit because it is not based on an investigation that had a scope and methodology that would provide a reliable basis for making such a conclusion.

KPMG’s Questions 2

Did the City enter into any agreement, including the “Managers Two” agreement, or otherwise take any actions that resulted in the underfunding or misuse of pension funds that is a violation of State, City or other laws?

City’s Comment on Question 2

Your comment on question 2 makes essentially three points. First, that the City’s potential liability for any violations of law from the alleged underfunding of the pension plan has been dealt with through the settlement of the Gleason case. Second, you state that there has never been any allegation that the City’s net pension obligation reported in the City’s balance sheet has been misstated. And third, that based on certain legal propositions discussed in the V&E Report at page 11, the motivations of individual members of the City Council in taking certain action are not a basis upon which that action may be voided by the courts.

Response to City’s Comment on Question 2

On point 1, GASB standards require governments to disclose certain violations of compliance requirements. NCGA Interpretation 6, Notes to the Financial Statements Disclosure, paragraph 4, states that the notes to the financial statements should disclose material violations of finance-related legal and contractual provisions. In addition, material violations, or potential violations, of finance-related legal and contractual provisions should be considered for recording a loss contingency. Accordingly we do not believe that only considering the loss contingency is sufficient in these circumstances. Additionally, the considerations in AU § 317.16 need to be addressed in the context of this question.



On point 2, The reported June 30, 2002 \$39 million net pension obligation was misstated due to the payment of retiree healthcare benefits from the pension plan. At KPMG's suggestion, The City has calculated the corrected June 30, 2002 net pension obligation to be \$103 million. The considerations in AU § 317.16 need to be addressed in the context of this question. The City needs to investigate and determine the relationship of the perpetration and concealment, if any, of likely illegal acts to specific control objectives and the level of management, employees, or consultants involved. For example, V&E states that a letter from the Actuary to Mike Phillips in 1998 highlights knowledge of potential errors in the financial statements that were not changed/corrected until recommended by KPMG for the June 30, 2003 financial statements:

“All these number presuppose that the 1996-97 is the first year in which the calculated actuarial contribution is greater than the actual contribution. You made an excellent point a year ago that this may not be the case. This issue may go back close to a decade after the use of ‘bifurcated’ rates was implemented. The case could be made that the City has a Net Pension obligation”.

Finally, on point 3, while the legal proposition to which you refer, while may be relevant to whether a court will decline to question the motivation behind proper legislative action for reasons grounded in separation of powers, we do not believe that such a consideration alters the nature of the our responsibilities as the City's independent auditor, nor the need for the City to perform additional inquiry before determining whether an illegal act has (or has not) occurred, and if so, that it has been appropriately remediated.

KPMG's Questions 3

Did the SDCERS Board breach their fiduciary duty by allowing the City to underfund the plan in exchange for additional benefits for current employees and could this action have been in violation of any laws?

City's Comment on Question 3

Your comment on this item is essentially that the SDCERS board is independent of the City of San Diego and based on that you question why the actions of SDCERS or the members of its board “relate to” KPMG's audit.

Response to the City's Comment on Question 3

The basic financial statement of the City consist of (a) the primary government, (b) organizations for which the primary government is financially accountable, and (c) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete.

The definition of the reporting entity is based primarily on the notion of financial accountability. A primary government is financially accountable for the organizations that make up its legal entity. It is also financially accountable for legally separate organizations if its officials appoint a



voting majority of an organization's governing body and either it is able to impose its will on that organization or there is a potential for the organization to provide specific financial benefits to, or to impose specific financial burdens on, the primary government. A primary government may also be financially accountable for governmental organizations that are fiscally dependent on it.

The City's basic financial statements include SDCERS, and any audit opinion issued by KPMG reporting on the City's basic financial statements would, therefore, cover SDCERS. Accordingly, financial accounting and disclosure of activities occurring within SDCERS are relevant to our audit under GAAS and GAGAS.

KPMG's Question 4

Is the use of surplus earnings to pay city obligations such as benefits outside of the plan illegal?

City's Comment on Question 4

Your comment refers us to the history of the surplus earnings issue as discussed in the V&E Report.

Response to City's Comment on Question 4

According to the Report, retiree healthcare benefits were paid directly out of the pension system from 1983 until 1992 when a determination was made that this violated federal tax regulations. A new system was set up, which was also later determined to be legally flawed in 1995, which was addressed by making payments a SDCERS benefit. Report at 36. This underscores, rather than ameliorates our concerns. We must understand what the City has done to address possible IRS sanctions, and also learn what the possible impact is to the City's June 30, 2003 financial statement amounts and disclosures. Additionally, we believe that the considerations raised by AU § 317.16 need to be addressed in the context of this question.

KPMG's Question 5

Did the City violate the City Charter by failing to fund its retirement plan as required by the City Charter?

City's Comment on Question 5

Your comment on this question refers us to the fact, discussed above, that the City believes that the Gleason settlement "resolves the economic consequences" of the City's actions and thus, suggests that any issue with respect to whether that conduct was unlawful is irrelevant.

Response to City's Comment on Question 5

Potential liabilities are one reason violations of laws are relevant to an auditor. Because GAAP require governments to disclose material (whether quantitative or qualitative) violations of



finance-related legal and contractual provisions, the auditor of a governmental entity should be alert to the possible financial reporting effect of noncompliance that has a material indirect effect on financial statements. Additionally, KPMG believes that the considerations of AU 317.16 needs to be addressed in the context of this question.

KPMG's Question 6

Did the SDCERS Board and/or the City violate the California Constitution by allowing the City to intentionally underfund the plan?

City's Comment on Question 6

Your comments in this section refer to your earlier comments relating to Question 2 and Question 3.

Response to City's Comment on Question 6

Please see our comments above regarding these items.

KPMG's Question 7

Was undue influence placed on the actuary to change assumptions to reduce the shortfall of the City's contribution compared to the Actuarial Required Contribution (ARC), and, if yes, at whose direction and what action does the City plan to take to rectify this action, if applicable?

City's Comment on Question 7

Your comment on this item refers us to the discussion at page 91 of the V&E Report and asks for the details of any remaining concerns.

Response to City's Comment on Question 7

The auditor should consider the implications of an illegal act in relation to other aspects of the audit, including the reliability of representations to be obtained from members of management. The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures and the level of management or employees involved.

The City needs to investigate and determine the relationship of the perpetration and concealment, if any, of likely illegal acts to specific control objectives and the level of management, employees, or consultants involved.



Other Issues Raised in the City's September 20, 2004 Letter

Your letter also commented on electronic discovery. With respect to electronic discovery, both the City and V&E have made it clear to KPMG on August 27, 2004 that V&E was not retained to investigate issues relating to intent and that the scope of its investigative efforts were not designed to do so. We believe that determining intent is required with respect to certain of the questions posed in our August 9 letter, and electronic discovery is an effective procedure in that regard, as it may provide relevant evidence for the City, its counsel, and KPMG to consider in determining whether there are unresolved questions which might affect the City's financial statements or disclosures.

April 13, 2004

Ms. Lisa Irvine
Director, Financial Management Department
The City of San Diego
202 C Street
San Diego, California 92101

Dear Ms. Irvine:

This letter will confirm KPMG LLP's ("KPMG") understanding of our engagement to report upon our audit of the financial statements of the City of San Diego (the "City") as of and for the year ended June 30, 2003.

Objectives and limitations of services

We will conduct the audit of the financial statements in accordance with auditing standards generally accepted in the United States of America and the standards for financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The objective of an audit carried out in accordance with such standards is the expression of an opinion as to whether the presentation of the financial statements conforms with accounting principles generally accepted in the United States of America. In conducting the audit, we will perform tests of the accounting records and such other procedures as we consider necessary in the circumstances to provide a reasonable basis for our opinion on the financial statements. We also will assess the accounting principles used and significant estimates made by management, as well as evaluate the overall financial statement presentation.

Our report will be addressed to the City Council of the City. We cannot provide assurance that an unqualified opinion will be rendered. Circumstances may arise in which it is necessary for us to modify our report or withdraw from the engagement. Our audit is planned and performed to obtain reasonable, but not absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, there is a risk that material errors, fraud (including fraud that may be an illegal act), and other illegal acts may exist and not be detected by an audit performed in accordance with auditing standards generally accepted in the United States of America. Also, an audit is not designed to detect matters that are immaterial to the financial statements.

Ms. Lisa Irvine
The City of San Diego
April 13, 2004
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In planning and performing our audit, we will consider the City's internal control in order to determine the nature, timing and extent of our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on internal control. The limited purpose of this consideration may not meet the needs of some users who require additional information about internal control. We can provide other services to provide you with additional information on internal control which we would be happy to discuss with you at your convenience.

As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we will perform tests of the City's compliance with certain provisions of laws, regulations, contracts and grants violations of which could have a direct and material affect on the financial statements. However, our objective is not to provide an opinion on overall compliance with such provisions.

Our responsibility to communicate with the City Council

In accordance with *Government Auditing Standards*, we will prepare a written report, *Report on Compliance and Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards* (GAS report), on our consideration of internal control and tests of compliance made as part of our audit of the financial statements. While the objective of our audit of the financial statement is not to report on the City's internal control and we are not obligated to search for reportable conditions as part of our audit this report will include any reportable conditions to the extent they come to our attention. Reportable conditions are significant deficiencies in the design or operation of internal control which could adversely affect the City's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements under audit. This report will also include all illegal acts and fraud and material violations of grants and contracts, and abuse. It will indicate that it is intended solely for the information and use of the City Council and management of the City and that it is not intended to be and should not be used by anyone other than these specified parties.

In accordance with *Government Auditing Standards* we will also issue a management letter to communicate other deficiencies in internal controls that are not reportable conditions and other violations of grants and contracts, and abuse that comes to our attention unless clearly inconsequential.

In accordance with *Government Auditing Standards*, we are also required in certain circumstances to report fraud or illegal acts directly to parties outside the auditee.

We will also communicate to you verbally disagreements with management or other serious difficulties encountered in performance of our audit or review services. We believe verbal

Ms. Lisa Irvine
The City of San Diego
April 13, 2004
Page 3

communication of matters such as those noted above is the appropriate forum to provide open and frank dialogue.

We will report to you, in writing, the following matters:

- Audit adjustments arising from the audit that could, in our judgment, either individually or in aggregate, have a significant effect on the City's financial reporting process. In this context, audit adjustments, whether or not recorded by the entity, are proposed corrections of the financial statements that, in our judgment, may not have been detected except through the auditing procedures performed.
- Uncorrected misstatements aggregated during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in aggregate.
- Other matters required to be communicated by Statement on Auditing Standards No. 61, *Communication with Audit Committees*.

We will also read minutes, if any, of audit committee meetings for consistency with our understanding of the communications made to you and determine that you have received copies of all material written communications between ourselves and management. We will also determine that you have been informed of i) the initial selection of, or the reasons for any change in, significant accounting policies or their application during the period under audit, ii) the methods used by management to account for significant unusual transactions and iii) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

If, in performance of our audit procedures, circumstances arise which make it necessary to modify our report or withdraw from the engagement, we will communicate to you our reasons for withdrawal.

Management responsibilities

The management of the City is responsible for the fair presentation, in accordance with generally accepted accounting standards, of the financial statements and all representations contained therein. Management also is responsible for preventing and detecting fraud, for adopting sound accounting policies and establishing and maintaining effective internal controls and procedures for financial reporting to maintain the reliability of the financial statements and to provide reasonable assurance against the possibility of misstatements that are material to the financial statements. Management also is responsible for informing us of all reportable

Ms. Lisa Irvine
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conditions, of which it has knowledge, in the design or operation of such controls. Management also is responsible for identifying and ensuring that City complies with laws, regulations, contracts and grants applicable to its activities, and for informing us of any known material violations of such laws and regulations.

The City agrees that all records, documentation, and information we request in connection with our audit will be made available to us, that all material information will be disclosed to us, and that we will have the full cooperation of the City's personnel. As required by auditing standards generally accepted in the United States of America, we will make specific inquiries of management about the representations embodied in the financial statements and the effectiveness of internal control, and obtain a representation letter from management about these matters. The responses to our inquiries, the written representations, and the results of audit tests comprise the evidential matter we will rely upon in forming an opinion on the financial statements.

In accordance with *Government Auditing Standards*, as part of our planning of the audit we will consider the results of previous audits and follow up on known significant findings and recommendations that directly relate to the objectives of the audit. To assist us, management agrees to identify previous financial audits, attestation engagements, performance audits, or other studies related to the objectives of the audit being undertaken and to identify corrective actions taken to address significant findings and recommendations prior to the date of our auditors' report.

Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any unrecorded misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements being reported upon. Because of the importance of management's representations to the effective performance of our services, the City agrees to release KPMG and its personnel from any claims, liabilities, costs and expenses relating to our services under this letter attributable to any misrepresentations in the representation letter referred to above.

Management is also responsible for providing us with written responses in accordance with *Government Auditing Standards* to the findings included in the GAS report within seven days of being provided with draft findings.

Management is responsible for the distribution of the reports issued by KPMG. In accordance with *Government Auditing Standards*, the reports issued citing *Government Auditing Standards* are to be made available for public inspection.

Ms. Lisa Irvine
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Offering documents

We understand that the City will, from time to time, wish to include these financial statements in a document offering securities and may request that we agree to include our report on these financial statements in the offering document. We will consider agreeing to the inclusion of our report by separate agreement.

Other engagement matters

The City has retained the law firm of Vinson & Elkins LLP ("Counsel") to conduct an independent investigation of the City's disclosures relating to pension matters in its municipal bond offering from 1996 to February 2004 and certain other matters (the "Investigation") and to prepare a written report with observations, conclusions and recommendations (the "Report"). The City agrees to provide complete and unrestricted access to the Investigation, including but not limited to the scope of the Investigation and the periods covered, procedures performed, people interviewed, interview notes or memoranda, other paper and electronic data collected, including responsive emails, email "search" terms used, findings, recommendations and remedial actions, if any. In addition, we will require a complete briefing as to the status of the Investigation as soon as possible after retaining KPMG and we will require weekly status updates.

We will not issue our auditors' report on the City's basic financial statements until such Investigation is complete. In the event that KPMG determines that the Investigation or any aspect thereof is insufficient to allow us complete our audit of the City's basic financial statements or any fund financial statements, KPMG may modify our report or withdraw from the engagement. KPMG requests and the City agrees that public announcements pertaining to KPMG's engagement as the City's auditors or its ongoing audit progress and findings will be subject to review and consent by KPMG prior to dissemination.

This letter shall serve as the City's authorization for the use of e-mail and other electronic methods to transmit and receive information, including confidential information, between KPMG and the City and between KPMG and outside specialists or other entities engaged by either KPMG or the City. The City acknowledges that e-mail travels over the public Internet, which is not a secure means of communication and, thus, confidentiality of the transmitted information could be compromised through no fault of KPMG.

Ms. Lisa Irvine
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Further, for purposes of the services described in this letter only, the City hereby grants to KPMG a limited, revocable, non-exclusive, non-transferable, paid up and royalty-free license, without right of sublicense, to use all names, logos, trademarks and service marks of the City solely for presentations or reports to the City or for internal KPMG presentations and intranet sites.

KPMG is a limited liability partnership comprising both certified public accountants and certain principals who are not licensed as certified public accountants. Such principals may participate in the engagements to provide the services described in this letter.

Work paper access by regulators and others

The work papers for this engagement are the property of KPMG. Pursuant to *Government Auditing Standards*, we are required to make certain work papers available in a full and timely manner to regulatory agencies upon request for their reviews of audit quality and for use by their auditors. In addition, we may be requested to make certain work papers available to regulators pursuant to authority given to it by law or regulation. Access to the requested work papers will be provided under supervision of KPMG personnel. Furthermore, upon request, we may provide photocopies of selected work papers to regulatory agencies. These regulatory agencies may intend, or decide, to distribute the photocopies or information contained therein to others, including other government agencies. We agree to maintain the work papers for a period of not less than seven (7) years.

In the event KPMG is requested pursuant to subpoena or other legal process to produce its documents relating to this engagement in judicial or administrative proceedings to which KPMG is not a party, the City shall reimburse KPMG at standard billing rates for its professional time and expenses, including reasonable attorney's fees, incurred in responding to such request.

Additional reports

We expect to issue as part of this engagement independent auditors' reports on the following:

- Financial Statements of the Metropolitan Wastewater Utility Fund;
- Financial Statements of the Water Utility Fund.

Ms. Lisa Irvine
The City of San Diego
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Other Government Auditing Standards matters

As required by *Government Auditing Standards*, we have attached a copy of KPMG's most recent peer review report and letter of comments.

We may also assist management in drafting the financial statements and notes. In accordance with *Government Auditing Standards*, we are required to confirm that management accepts responsibility for the financial statements and notes and, therefore, has a responsibility to be in a position in fact and appearance to make an informed judgment about them and that management will:

- Designate a qualified management-level individual to be responsible and accountable for overseeing the drafting of the financial statements.
- Establish and monitor the performance of the engagement to ensure that it meets management's objectives.
- Make any decisions that involve management functions related to the engagement and accept full responsibility for such decisions.
- Evaluate the adequacy of the financial statements and notes.

Timing

The City requests, and KPMG agrees, that KPMG will commence its audit of the financial statements for the fiscal year ended June 30, 2003, for the City's basic financial statements, and the audits of the Metropolitan Wastewater Utility fund and Water Utility fund financial statements for the fiscal year ended June 30, 2003 at the same time. However, no assurance can be given as to the completion of our audits or the timing of the issuance of the auditors' reports on either the basic financial statements, the Metropolitan Wastewater Utility fund financial statements or the Water Utility fund financial statements.

Compensation

Our fees will be based on the following hourly rates:

Partner	\$400
Senior Manager	\$350
Senior Associate	\$200

Ms. Lisa Irvine
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Associate	\$150
Clerical	\$ 60

In addition, expenses for items such as travel, telephone, postage, and typing, printing and reproduction of the financial statements will be billed for reimbursement as incurred.

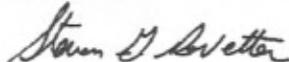
KPMG estimates that the cost of all services pursuant to this engagement will be approximately \$700,000 to \$800,000. This is an estimate only, and the City acknowledges that additional expenditures may be required to complete the engagement. This agreement shall be supplemented as appropriate upon the further authorization of the City Council.

This agreement may be terminated at any time by the City or KPMG for convenience, but the City agrees that KPMG will be compensated for actual services rendered pursuant to this agreement at the hourly rates and expenses as set forth in the table set forth above, but in no event in an amount exceeding the amount authorized by the City Manager and, if applicable, by the City Council. KPMG shall provide weekly billings for its services; payment is due within ten (10) days of receipt. We understand that Lisa Irvine will be the contract administrator for our engagement.

We shall be pleased to discuss this letter with you at any time. For your convenience in confirming these arrangements, we enclose a copy of this letter. Please sign and return it to us.

Very truly yours,

KPMG LLP



Steven DeVetter
Partner

Ms. Lisa Irvine
The City of San Diego
April 13, 2004
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ACCEPTED:

The City of San Diego

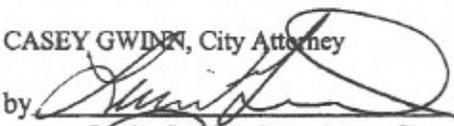


Lisa Irvine, Director, Financial Management Department

4/13/2004

Date

APPROVED AS TO FORM AND CONTENT:

CASEY GWIDEN, City Attorney
by 

Leslie J. Girard, Assistant City Attorney



KPMG LLP
Three Embarcadero Center
San Francisco, CA 94111

Telephone 415 951 0100

August 9, 2004

Mr. Leslie J. Girard
Assistant City Attorney
Office of the City Attorney
City of San Diego
1200 Third Avenue, Suite 1620
San Diego, CA 92101

Re: Investigation

Dear Mr. Girard:

To date, we have had several discussions with Paul Maco of Vinson & Elkins (V&E) and have read the material provided by V&E with reference to their investigation and the formal inquiry and investigation being conducted by the Securities and Exchange Commission (SEC), the Department of Justice and US Attorney Office. Based on these discussions and our reading of the documents provided, we understand the following:

1. In September 2003, Ms. Diann Shipione, a San Diego City Employees' Retirement System (SDCERS) Board Member and Trustee, notified city officials and underwriters of errors and omissions in the City's financial statements dating back to 1996 and asserted the errors falsely improved the City's financial condition and were done intentionally to misstate and hide the real condition of the pension system.
2. Subsequent to the notification by Ms. Shipione, the City retracted the Preliminary Official Statement relating to a \$505 million bond offering, filed a voluntary disclosure statement with the SEC acknowledging errors and omissions and engaged V&E to investigate and issue a report on the disclosure practices of the City.
3. The city has sold more than \$2.3 billion in municipal bonds using financial statements believed to contain certain errors or omissions.
4. Ms. Shipione has alleged in various communications with the City Council, Mayor and other top city officials, that the steps taken to deliberately underfund the plan are illegal, violate the City Charter, and are at odds with statutes and court cases of the State of California.
5. Ms. Shipione has alleged that the decision to allow the underfunding was reached through a corrupt process in which the required funding was deferred to garner benefits for current employees.





Mr. Leslie J. Girard
Assistant City Attorney
Office of the City Attorney
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6. On June 11, 2004, the City reached a tentative settlement on the Gleason lawsuit. The Gleason lawsuit alleged that the underfunding of the pension plan was illegal and violated the City Charter, Municipal Code and California Constitution and that the SDCERS Board breached their fiduciary duties by allowing the City to underfund the plan. The settlement was reached without resolving the legal questions raised.
7. The SEC launched a formal inquiry in February 2004 under the anti-fraud provisions of section 17(a) 2&3 of the Securities Act of 1933 with reference the City's previous bond offerings. As part of that inquiry, we understand that the SEC may be considering allegations made in the press, and in particular allegations made by Ms. Shipione.
8. An e-mail provided to the SEC appears to indicate the SDCERS actuary may have worked with the City to change assumptions with the intent of lowering the calculated actuarial required contribution by the City.

AICPA Professional Standards state in section AU 317:

.10 When the auditor becomes aware of information concerning a possible illegal act, the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor should inquire of management at a level above those involved, if possible. If management does not provide satisfactory information that there has been no illegal act, the auditor should—

- a. Consult with the client's legal counsel or other specialists about the application of relevant laws and regulations to the circumstances and the possible effects on the financial statements. Arrangements for such consultation with client's legal counsel should be made by the client.
- b. Apply additional procedures, if necessary, to obtain further understanding of the nature of the acts.

As indicated in our engagement letter dated April 13, 2004, we will not issue our auditors' report until a determination is made that the investigation being conducted by V&E is sufficient and complete. We acknowledge V&E's effort and cooperation in explaining the process they are undertaking to KPMG.

Based on discussions with you, V&E, and the reading of the documents provided and, consistent with our previous conversations, we are providing you the following



Mr. Leslie J. Girard
Assistant City Attorney
Office of the City Attorney
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observations regarding our understanding of the scope of the investigation to help avoid surprises once we review the draft report.

We believe the investigation being conducted by V&E should address and resolve the following questions:

1. Whether or not the financial statements and or the disclosures in the financial statements were intentionally misleading and, if yes, what individuals were involved and what, if any, remedial action is recommended?
2. Did the City enter into any agreement, including the "Managers Two" agreement, or otherwise take any actions that resulted in the underfunding or misuse of pension funds that is a violation of State, City or other laws?
3. Did the SDCERS Board breach their fiduciary duty by allowing the City to underfund the plan in exchange for additional benefits for current employees and could this action have been in violation of any laws?
4. Is the use of surplus earnings to pay city obligations such as benefits outside of the plan illegal?
5. Did the City violate the City Charter by failing to fund its retirement plan as required by the City Charter?
6. Did the SDCERS Board and/or the City violate the California Constitution by allowing the City to intentionally underfund the plan?
7. Was undue influence placed on the actuary to change assumptions to reduce the shortfall of the City's contribution compared to the ARC, and, if yes, at whose direction and what action does the City plan to take to rectify this action, if applicable?

It is our understanding that the electronic evidence gathered by the investigation has been limited to documents identified by City employees in response to a SEC subpoena. In order to adequately address the allegations raised, we believe the investigation should consider conducting independent electronic discovery.

As the investigation progresses and we are provided access to information as outlined in our engagement letter, we may request that the investigation consider additional items.



Mr. Leslie J. Girard
Assistant City Attorney
Office of the City Attorney
City of San Diego
August 9, 2004
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We respectfully request your written response to these questions regarding the investigation.

Very truly yours,

KPMG LLP

A handwritten signature in black ink, reading 'Steven G. DeVetter'. The signature is written in a cursive, flowing style.

Steven G. DeVetter
Partner



KPMG LLP
Three Embarcadero Center
San Francisco, CA 94111

Telephone 415 951 0100

September 1, 2004

Leslie J. Girard, Esq.
Assistant City Attorney
Office of the City Attorney
City of San Diego
1200 Third Avenue, Suite 1620
San Diego, CA 92101

Re: Follow-up from meeting on August 27, 2004

Dear Mr. Girard:

We write to follow-up on our meeting on Friday in San Diego. We appreciate the opportunity afforded by that meeting to hear from the Vinson & Elkins ("V&E") representatives a status report on their investigation and to discuss with them and with you our respective views on the scope of the investigation as well as how its results will be shared with us.

On several occasions over the last few months we have had discussions about the investigation and we think it is fair to say that over that period we have expressed concerns about the scope of the investigation as it has been described to us. We expressed some of those concerns in our August 9, 2004 letter. While we remain concerned that the scope of the investigation may not be sufficient to enable us to conclude that the City has adequately addressed certain issues pertinent to our audits of the City's financial statements, we are prepared to proceed as outlined in our meeting by continuing to review the additional information being provided to us while we await the opportunity to review the final report.

Based upon our discussion on Friday, we understand that a number of the concerns raised in our August 9, 2004 letter may be addressed to some extent in the V&E report. However, you and V&E made it clear that V&E was retained only to investigate the City's disclosure practices and that, while there may be factual information pertinent to our broader concerns discussed in the report, we should not anticipate that all of the questions identified in our August 9, 2004 letter to you will be answered by the report. We will work diligently to review the information provided to us, determine whether such information is sufficient for our purposes and discuss our conclusions with you. We also appreciate your assurances that we will have access to V&E to discuss their report and the investigation; that the City will respond fully to any questions KPMG may pose that may not be addressed in the V&E report; and that the City is not imposing any deadline on KPMG to complete its work.

However, without in any way prejudging what our reaction to the final report will be, you should be aware that, if following our review of the V&E report we conclude that the V&E report is not sufficient to resolve all of the issues we face in the audit, we may advise you that additional investigative procedures may be necessary before KPMG can complete its work. In certain circumstances, we, as auditors may be obligated





Leslie J. Girard, Esq.
September 1, 2004
Page 2

to raise any unresolved questions with the City Council which, according to our engagement letter, is the body to which our audit report is to be addressed. In addition, KPMG reserves the right to resign this engagement if it concludes, in its professional judgment, that the City's investigation of these issues has not been sufficiently comprehensive to enable KPMG to reach conclusions necessary for the issuance of an audit report.

In light of the issues currently facing us and to ensure that KPMG's position is clear to all concerned, we believe it is appropriate that we provide a copy of this letter to Lamont Ewell, City Manager, and Terri Webster, Acting City Auditor and Comptroller.

Thank you again for your time on Friday. Please contact us at your convenience to discuss any of the foregoing issues in greater detail.

Very truly yours,

KPMG LLP

A handwritten signature in black ink that reads "Steven G. DeVetter". The signature is written in a cursive, flowing style.

Steven G. DeVetter
Partner

cc: Mr. P. Lamont Ewell, City Manager
Ms. Terri Webster, Acting City Auditor and Comptroller

LESLIE E. DEVANEY
ANITA M. NOONE
LESLIE J. GIRARD
SUSAN M. HEATH
GAEL B. STRACK
ASSISTANT CITY ATTORNEYS

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO

Casey Gwinn
CITY ATTORNEY

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

September 20, 2004

VIA FACSIMILE AND U.S. MAIL

Mr. Steven G. DeVetter, Partner
KPMG
Three Embarcadero Center
Suite 2000
San Francisco, CA 94111-4073
Fax: (415) 986-3439

Dear Mr. DeVetter:

Re: City of San Diego Fiscal Year 2003 Audit

I am writing in response to the letters of KPMG dated August 9, 2004 and September 1, 2004. At the outset, let me express the City's intention to assist KPMG in performing all reasonable steps necessary in order to conduct the audit of the financial statements of the City of San Diego (the "City") as we have to date, in accordance with auditing standards generally accepted in the United States and the standards for financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States

As stated in our letter agreement with KPMG dated April 13, 2004 (the "Agreement"), the City retained the law firm of Vinson & Elkins LLP ("Counsel") to conduct an independent investigation of the City's disclosures relating to pension matters in its municipal bond offering from 1996 to February 2004 and certain other matters (the "Investigation") and to prepare a written report with observations, conclusions and recommendations (the "Report"). On September 16, 2004, Counsel filed the Report with the Office of the City Clerk and the City Council will receive the report in open session today at 2:00 p.m. The Report fully satisfies, and indeed exceeds, the requirements of our terms of engagement with Counsel. We believe that the City is the only municipal government to have commissioned an investigative report of its disclosure practices. However, we ask that, to the extent you are aware of similar reports prepared for municipal governments, you share the portions you consider relevant with us.

The City now wishes to determine what additional needs, if any, KPMG has in order to issue its audit opinion with respect to the City's Fiscal Year 2003 Comprehensive Annual

Financial Report ("2003 CAFR"), as well as the additional services covered by the Agreement. Your correspondence to date does not clarify this issue in light of the Report.

Please regard the following comments in response to your letters as made in order to further the dialogue between the City and KPMG. In your letter of August 9, you made certain initial observations that we believe misinterpret documents and records provided to you. For example, you state that SDCERS Trustee Diann Shipione has "pointed out" errors in the City's accounting going back to 1996. To our knowledge, Ms. Shipione has never alleged *any* errors in the City's financial statements other than with respect to one statement in a footnote to the City's financial statements for the fiscal year ended June 30, 2002. As discussed in the Report at page 109, that error, which was certainly not material in itself, was the result of a failure to update the City's footnote disclosure from the previous year (when the statement was accurate). The footnote did have other, more serious problems, as Paul Webber and City staff later discovered. Ms. Shipione's criticisms have, in the main, gone not to the City's accounting but to its failure to adequately fund SDCERS. The Report, as a general matter, agrees with these criticisms and discusses in detail their relevance to the City's financial disclosure.

As another example, you stated that the CERS actuary "may have worked with the City to change assumptions with the intent of lowering the calculated actuarial required contribution by the City." In the communication at issue, Mr. Roeder did not propose any change in actuarial "assumptions." He pointed out that under applicable standards, it is permissible to use a different amortization period for expensing a pension system's unfunded actuarial accrued liability than is used for calculating employer contributions. This view was confirmed in documents provided to you that express the views of Gary Caporicci, Caporicci & Larson, and Leslie Finertie, an actuary with the firm of Towers Perrin. In his review of the City's financial disclosure, this view was also accepted by Paul Webber, Orrick Herrington. If you have reason to believe these opinions are incorrect, please so inform us. We will request that Counsel make itself available at your convenience to discuss these and other matters that appear from your correspondence to be of concern to KPMG.

With respect to the seven questions raised in your letter, please note my comments below:

Question 1, Comment. As the City publicly disclosed on January 27, 2004, the footnotes to the City's financial statements for the fiscal year ended June 30, 2002, contained various errors and omissions. Some of these errors and omissions also affected previous years' financial disclosure. The footnotes were prepared, as required by contract, by the City's former independent auditor, Calderon, Jaham, and Osborn, which firm was acquired by Caporicci and Larson in January 2003. The City has terminated its relationship with Caporicci and Larson. The City's financial statements for the relevant period were prepared under the supervision of the former City Auditor and Comptroller, Ed Ryan. Mr. Ryan retired on February 13, 2004. He declined to be interviewed by Counsel in connection with its Report. The City is actively engaged in finding a new Auditor and Comptroller. The Report addresses on page 159 the issue

of the possible intent of City officials to allow the City to issue misleading financial disclosure. We would appreciate being referred to relevant extracts from investigative reports for municipal issuers or other issuers that address the issue of intent in a manner that goes beyond this statement.

Question 2. Did the City enter into any agreement ... or otherwise take any actions... that is a violation of State, City, or other laws?

Question 2, Comment. Please note that the City's potential liability for any violations of law arising from the alleged underfunding of its pension system was addressed through settlement in the recent *Gleason* suit. According to the terms of the settlement, the terms are binding upon all who might have standing to sue on such matters. To our knowledge there are no other claims that have been asserted in connection with the City's relationship to its pension system, or related disclosure issues. To the extent any potential claims can be identified, we will, of course, have no objection to appropriate disclosure of the related contingent liabilities.

As you know, the only direct reflection of the City's obligation to fund SDCERS in the City's balance sheet is the line item "net pension obligation." We are not aware of any allegations that this item has ever been materially misstated. Various errors in the City's previous footnote disclosure concerning pension matters are discussed in detail in the Report and in the City's January 27, 2004 voluntary disclosure. If you have any reason to believe the City's disclosure of these errors and omissions is in any way incomplete or inadequate, please so inform us.

More generally, please note the general, long standing, principle of the law of municipal corporations cited in the Report at page 11: "A legislative act by a city council that violates or is not in compliance with that city's charter is void, but the actions of the individual members of the city council in taking such action generally are not open to challenge in the courts, and where the enactment of legislation is challenged as resulting from improper or fraudulent motives, the law may not be voided on such grounds." Please identify and explain for us the details of any remaining concerns under Question 2 that affect your ability to issue your audit letter under GAAS, so that we may determine appropriate actions to address your concerns.

Question 3, Comment. The actions of the SDCERS Board are described in the Report, including the extensive reliance upon fiduciary counsel. The SDCERS Board is independent of the City of San Diego. Three of the thirteen Trustees of SDCERS are, by City Charter, officials of the City. Please identify and explain for us (a) how actions of an entity independent of the City and (b) the three City individuals serving as SDCERS Trustees, relate to your audit letter under GAAS so that we may determine appropriate actions to address your concerns.

Question 4, Comment. The history of the use of surplus earnings is discussed in Part II of the Report. Please identify and explain for us the details of any remaining concerns under

Question 4 that affect the issuance of your audit letter under GAAS so that we may determine appropriate actions to address your concerns.

Question 5, Comment. See the discussion under Part II and note that the *Gleason* settlement resolves the economic consequences of the City's actions. Please identify and explain for us the details of any remaining concerns under Question 5 that impair the issuance of your audit letter under GAAS so that we may determine appropriate actions to address your concerns.

Question 6, Comment.

(a) SDCERS. Please note that the SDCERS Board is a separate legal entity from the City. The Report contains a discussion of actions of the SDCERS Board, but such discussion is subject to the limited cooperation and access to relevant information provided by this entity. As with Question 3, please identify and explain for us (a) how actions of an entity independent of the City and (b) the three City individuals serving as SDCERS Trustees, relate to your ability to issue and impair the issuance of your audit letter under GAAS so that we may determine appropriate actions to address your concerns.

(b) The City. An analysis of the actions of the City is contained in the Report. In light of the general legal principle cited in the Report as described in the Comment to Question 2 and the resolution of any economic exposure resulting from such actions through the *Gleason* settlement, please identify and explain for us the details of any remaining concerns under Question 6 that affect the issuance of your audit letter under GAAS so that we may determine appropriate actions to address your concerns.

Question 7, Comment. Please note the discussion on page 91 of the Report concerning any undue influence on the SDCERS actuary in connection with Manager's Proposal 2. Please explain for us the details of any remaining concerns under Question 7 that impair the issuance of your audit letter under GAAS so that we may determine appropriate actions to address your concerns.

With respect to your suggestion that we consider independent electronic discovery, given the findings of the Report, and considering the lack of interest by the SEC and US Attorney expressed in such activity, as well as the additional cost to the City, please identify and explain for us the details of any remaining concerns relating to the use of independent discovery that affect the issuance of your audit letter under GAAS so that we may determine appropriate actions to address your concerns.

We note that Counsel has produced the key documents behind the Report to you in two shipments, one delivered Saturday and one sent today. Please advise us of any additional requests you have.

We are encouraged that KPMG has retained the services of Sidley, Austin, Brown and Wood in this matter. In addition to their expertise in the representation of accounting firms, we are aware of their expertise in municipal finance.

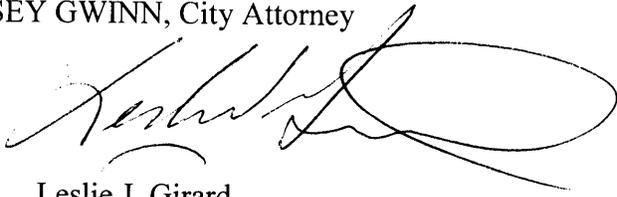
We are sensitive and intend to support KPMG in meeting its professional obligations prior to issuing its audit report. We ask that KPMG recall the oral assurances KPMG provided the City at the time it pursued this engagement this past spring, in particular its sensitivity to the timing needs of the City to be able to enter the public securities markets. We are now advised by Standard & Poore's Rating Services that they have suspended the City's rating "due to the continued absence and lack of estimated release date for the city's fiscal 2003 audited financial statements." As a result, our bondholders and the City may suffer economic harm.

In our view the Report is sufficiently comprehensive to allow you to reach the conclusions necessary for compliance with Section AU 317 of the AICPA Professional Standards and for the issuance of your audit report. We also believe this letter addresses each of the particular questions that you raised in your previous correspondence. After your review of this letter, please call me so that we can schedule a timely meeting to discuss any remaining issues relating to the impact on the financial statements and the issuance of the audit report.

Sincerely,

CASEY GWINN, City Attorney

By



Leslie J. Girard
Assistant City Attorney

LJG:km
cc: City Manager



KPMG LLP
Three Embarcadero Center
San Francisco, CA 94111

Telephone 415 951 0100

October 27, 2004

Leslie J. Girard, Esq.
Assistant City Attorney
Office of the City Attorney
City of San Diego
1200 Third Avenue, Suite 1620
San Diego, CA 92101

Re: City of San Diego Fiscal Year 2003 Audit

Dear Mr. Girard:

We received your October 21, 2004 email with the attached proposed Investigation Program (Program). The Program appears to indicate that Vincent & Elkins will conduct some additional interviews, but does not appear to anticipate the conduct of a detailed investigation that will enable the City to reach necessary conclusions on the issues identified in our October 11, 2004 letter and attachments, which were discussed with you on October 14, 2004. Based on that discussion, we understood the City intended to propose an investigative plan that would address in detail the issues identified in our October 11 letter. We also believed, based on that discussion and our prior communications, that the City understood that such an investigation would necessarily include, not only interviews, but appropriate document collection and review (including emails and electronic documents), sufficient to answer the issues raised in our letter. In this regard, we also made clear that it is necessary that the investigator analyze all of the information accumulated and reach conclusions as to whether any conduct identified in its investigation constitutes a violation of any laws, rules or regulations having the force of law, and, if so, whether the City's actions have, or proposed actions will, adequately remediate any such violation or possible violation.

We believe that your engagement letter with Vincent & Elkins should include a clear statement of the expected scope of the investigation, including that it will address the questions raised by our October 11 letter, and the City's expectation that the Vincent & Elkins will state conclusions on those questions. Thus, contrary to the proposed Program sent to us, Vincent & Elkins, as investigating counsel, will be the party reaching those conclusions, not KPMG. KPMG's role, as independent auditor, is to evaluate whether the investigation, including its scope, methodology and conclusions, appears sufficiently comprehensive and reasonable and, thus, adequate for KPMG's audit purposes. We request that you provide us with a copy of any engagement letter entered into with Vincent & Elkins.

Additionally, please be advised, that to the extent the proposed Program appears to suggest that KPMG has or will undertake to promise that it will not require further work it may feel to be necessary and to issue its audit report without regard to the investigation's findings, KPMG cannot accept any limitations on, or conditions for, the performance of our audit. We intend to, and will, comply with generally accepted auditing standards and our engagement letter.





Leslie J. Girard, Esq.
Assistant City Attorney
Office of the City Attorney
City of San Diego
October 27, 2004
Page 2

We remain prepared to meet with the City to discuss how the City plans to conduct an adequately detailed investigation that will permit KPMG to conclude its audit. KPMG believes that resolution of these issues will be expedited if the City were to request Vincent & Elkins to prepare and forward to us a comprehensive and detailed work plan consistent with the concerns expressed above and in our previous communications.

Very truly yours,

KPMG LLP

A handwritten signature in black ink that reads "Steven G. DeVetter". The signature is written in a cursive, flowing style.

Steven G. DeVetter
Partner

cc: Mr. Dick Murphy, Mayor
Mr. P. Lamont Ewell, City Manager
Ms. Terri Webster, Acting City Auditor and Comptroller
City Council Members



Three Embarcadero Center
San Francisco, CA 94111

Telephone 415 951 0100

October 29, 2004

The Honorable Dick Murphy, Mayor
Mr. Lamont Ewell, City Manager
City of San Diego
1200 Third Avenue
San Diego, CA 92101

Gentlemen:

We write this letter in an earnest attempt to make progress with the City of San Diego towards addressing the issues that must be resolved before KPMG can complete its audit of the City's 2003 financial statements.

The immediate topic we must address is the letter dated October 28, 2004 from Paul Maco of Vinson & Elkins (V&E) addressed to Les Girard, Assistant City Attorney. That letter, which appears to have been posted immediately on the City's website, in our opinion seriously impairs, rather than advances, the prospects for a prompt resolution of the issues that currently stand in the way of KPMG completing its audit.

We will not in this letter seek to correct all of the statements in Mr. Maco's letter which we believe are inaccurate. However, we do wish to convey to you, as two individuals with significant responsibility for the City's affairs, several points, which are intended to be direct, but constructive:

First, KPMG cannot, and will not, complete an audit of the 2003 financial statements unless the City completes an independent investigation of potential illegal acts as we have outlined in our prior correspondence.

Second, KPMG does not seek, as Mr. Maco asserts, "broad and unspecified assurances that the City and its officials have not committed 'illegal acts.'" Nor do we request that the City retain counsel to "speculate on an unbounded universe of unasserted claims." We believe that our prior letters cannot reasonably be construed to have made such requests. To the contrary, we have laid out what our concerns are, and repeatedly advised the City's representatives that these concerns must be addressed through an investigation that was designed to develop facts that would enable the City and its counsel to address those concerns.

Third, while we believe it is somewhat unusual for an auditor to provide a detailed explanation to a client of the auditing standards that justify an auditor's request for information, we have done so here. In our correspondence, we not only discussed relevant auditing literature, but also explicated for the City some of the applicable accounting principles that require the City in its financial





The Honorable Dick Murphy, Mayor
Mr. Lamont Ewell, City Manager
City of San Diego
October 29, 2004
Page 2

statements to make disclosures of any violations of finance-related laws and regulations.¹ We believe that the City cannot comply with this requirement unless it conducts the kind of investigation we have requested and described in our October 11, 2004 letter. Accordingly, the investigation we are requesting is one that the City ought to desire to complete so that it can discharge its own financial reporting obligations and not solely because KPMG is insisting that it do so. The City, as the issuer of its financial statements, must conclude on the question of whether any of the issues discussed in our October 11, 2004 letter and its attachments and the conduct discussed in the V&E report was illegal and, if so, whether any violations must be disclosed, and have been adequately disclosed, in the financial statements in accordance with GAAP. We would further expect the City would also determine to its satisfaction that all necessary and appropriate remedial actions have been taken with respect to conduct that is investigated. It is because it is the City's obligation to reach these conclusions that KPMG has suggested that the City obtain from its investigators sufficiently clear legal conclusions to enable the City to make the necessary determinations; we have not, as Mr. Maco suggests requested that any law firm issue a legal opinion to KPMG on any subject and his allusion to the ABA protocol for FAS 5 (Contingent Liability) attorney letters is completely off subject. It is, thus, extremely disappointing and surprising that Mr. Maco's letter so ardently contends that KPMG has not explained the auditing standards motivating its request. It is equally troubling that his letter erroneously asserts that KPMG "was not following established auditing standards."²

In light of the foregoing, and considering both that Mr. Maco may not speak for the City on these matters and that (at least according to certain press reports) there may not have been adequate communication within the City about our position, we believe that a key element of our meeting on Monday November 1, 2004 will be to secure the authoritative position of the City on these important issues. Our fundamental goal for this meeting is the same one we expressed in our letter dated October 27, 2004: "to discuss how the City plans to conduct an adequately detailed investigation that will permit KPMG to conclude its audit."

If the City is prepared to proceed with an appropriate investigation, then we urge you to consider retaining counsel other than V&E to do so. The positions asserted in, and oppositional tone of, Mr. Maco's letter raises questions about V&E's willingness or ability in these circumstances to complete the investigation of, and reach conclusions on, the audit-critical questions posed in our prior oral and written communications and to do so in an objective and independent manner. Our

¹ In light of these requirements, the fact that the City may be exempt from Section 10A of the Securities Exchange Act of 1934 as Mr. Maco asserts, does not eliminate the City's obligations under Generally Accepted Accounting Principles ("GAAP") applicable to governments.

² Again, in the interest of assisting the City in understanding its obligations and explaining the professional guidance that KPMG believes is applicable here, we are enclosing a copy of a very recent Practice Alert published by the American Institute of Certified Public Accountants on "Illegal Acts".



The Honorable Dick Murphy, Mayor
Mr. Lamont Ewell, City Manager
City of San Diego
October 29, 2004
Page 3

reading of the letter suggests to us that, at this point, conducting the kind of investigation that is necessary may be in tension with V&E's ongoing representation of the City in the pending SEC investigation.

KPMG's ability to complete its audit of the City's financial statements is dependent on resolution of these outstanding issues. We have been, and will continue, to perform the service we understood the City wanted us to perform (i.e. to objectively exercise our professional judgment in the application of professional standards). We stand ready to do so in the independent manner we believe the City, the investing public and the taxpayers expect.

Very truly yours,

KPMG LLP

A handwritten signature in black ink that reads 'Steven G. DeVetter'.

Steven G. DeVetter
Partner

cc: Mr. Leslie Girard, Assistant City Attorney, City of San Diego



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February 3, 2005

The Honorable Dick Murphy, Mayor
Mr. Lamont Ewell, City Manager
Mr. Michael Aguirre, City Attorney
City of San Diego
1200 Third Avenue
San Diego, CA 92101

Mr. Paul S. Maco
Vinson & Elkins L.L.P.
The Willard Office Building
1455 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-1008

Gentlemen:

In light of recent events relating to the ongoing investigations by the City of San Diego¹, we have been asked to express in writing KPMG's views on certain issues relating to the scopes of those investigations. We regard this as an unusual request, especially given that it appears to have been triggered by a disagreement between two City officials over whether an adequate investigation can be done if the SDCERS does not waive its claims of attorney-client privilege. This disagreement underscores the importance of resolving an issue we have raised with the City on previous occasions, which is to identify the City official(s), Council members, subcommittee or other municipal body, that will take ultimate responsibility for the oversight and completion of an adequate investigation, ensure that a full and complete report of all relevant matters is made to the City Council, and deliver to KPMG the representations necessary to the completion of a financial statement audit in these circumstances.

Nonetheless, we provide this letter in an attempt to assist the City in completing its ongoing investigations. It does not exhaustively summarize all of our prior oral and written communications with the City and its investigators, and it does not retract, supercede or revise the substance of those communications. This letter is also subject to the terms of our engagement letter, which specifically provides that KPMG must consent to any public dissemination of information pertaining to its services. KPMG does not consent to the public dissemination of this letter and we believe that its distribution should be limited to those directly involved in conducting or overseeing the investigations.

Throughout our engagement to date, we have attempted to make clear that, in our view, the City needs to control, and, through its investigators, conduct the investigations, reach conclusions about potential violations of laws and regulations and take appropriate remedial actions. KPMG is not responsible for the conduct of the investigations, nor for determining what investigative procedures the City and its investigators will conduct. We expect the investigators, and then the

¹ We understand that Vinson & Elkins is leading one investigation and that the City Attorney is also conducting an investigation.



The Honorable Dick Murphy, Mayor
Mr. Lamont Ewell, City Manager
Mr. Michael Aguirre, City Attorney
Mr. Paul S. Maco
February 3, 2005
Page 2

City, to determine what information must be obtained and considered in order for the City to have assurance that investigations have adequately addressed all relevant issues and are sufficient to support the City's conclusions as to whether it is, or is not, likely that an illegal act has occurred and what remedial action is necessary or appropriate, if any.

We have been asked to state a position on whether SDCERS must waive attorney-client privilege. That is a judgment KPMG is not in a position to make. That issue must be decided by the City in conjunction with its investigator(s); and we would expect the City to determine what effect the absence of any relevant information (whether due to an assertion by SDCERS of privilege or any other reason) has on its ability to determine that all necessary information has been obtained and considered in order to complete thorough investigations. We would expect that any inability of the investigator(s) to obtain and consider relevant information is a factor we would consider in evaluating our ability to rely on the results of the investigation(s) when completed. In the event that KPMG determines that the investigation(s), or any aspect thereof, are insufficient to enable us to conclude that matters have been adequately investigated, KPMG may find it necessary to modify our report, disclaim an opinion, or withdraw from the engagement.

As noted, the investigative steps being undertaken are the responsibility of the investigators. We have, however, discussed scope and investigative steps with the City and in the course of those discussions we have attempted to make it clear that there are certain issues of scope that we believe should be regarded as important, including but not limited to the fact that the investigation(s) must address potential illegal acts at SDCERS. We have previously advised the City that we did not believe we could rely on an investigative process in which SDCERS was carved out of the investigation on the basis of an assertion that it is a separate legal entity from the City. We believe that the City and its investigators have acknowledged this and intended to address this concern since they have incorporated specific steps directed to SDCERS into their investigative work plans. We believed that those City representatives with whom we met recognized the importance of this issue and were committed to using all resources available to the City to cause SDCERS to provide the necessary information to the investigator(s), including the possibility of having the City Council pass a resolution requesting the SDCERS board to commit to cooperating fully with the investigation(s).

We have also discussed generally that, should particular investigative steps that were planned turn out to be impossible to perform, we would discuss with the investigative team the alternatives that they believed might meet the objective of the step. Nevertheless, it does appear, based on our current understanding of the facts, that it is essential that the investigations have access to documents and interviews from SDCERS, including, without limitation, such materials



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Mr. Lamont Ewell, City Manager
Mr. Michael Aguirre, City Attorney
Mr. Paul S. Maco
February 3, 2005
Page 3

as SDCERS may have that are within the scope of the subpoenas we understand were served on it in connection with ongoing government investigations.

Very truly yours,

KPMG LLP

A handwritten signature in black ink that reads "Steven G. DeVetter". The signature is written in a cursive style with a large, stylized 'S' and 'D'.

Steven G. DeVetter
Partner



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April 29, 2005

The Honorable Dick Murphy, Mayor
Honorable Members of the City Council
City of San Diego

Mr. Lynn Turner
Mr. Arthur Levitt
Mr. Troy Dahlberg
Kroll Associates, Inc., in its capacity as the
Audit Committee of the City of San Diego

Re: City of San Diego Fiscal Year 2003 Financial Statement Audit

Dear Gentlemen and Ladies:

In light of recent events relating to the ongoing investigations being conducted by the City of San Diego, we wish to communicate with you to avoid any confusion on the part of the City or its officials regarding our view regarding certain matters. This letter is subject to the terms of our engagement letter, which specifically provides that KPMG must consent to the public dissemination of information pertaining to its services. KPMG does not consent to the public dissemination of this letter and we believe that its distribution should be limited to those directly involved in conducting or overseeing the pending investigation(s).

In previous correspondence we have communicated to the City that KPMG can not, and will not, complete its audit of the City's 2003 financial statements and issue an auditor's report unless and until the City completes a thorough, independent and objective investigation of possible illegal acts as we have outlined in our prior letters. We have communicated that it is the responsibility of the City, as issuer of the financial statements, to conclude on the questions of whether any conduct identified by any of the pending investigations constitutes an illegal act, the impact of any identified illegal act on the financial statements (if any), whether any such illegal act must be (or has been) disclosed by the City in its financial statements, and determine what (if any) action is necessary or appropriate to remedy any identified illegal act and to execute such remedial action. We have also identified for the City the applicable professional standards that require the City to conduct a thorough, objective investigation.

We are aware that, in recognition of and to execute its responsibilities in this regard, the City Council retained Kroll Associates, Inc. on February 10, 2005 and subsequently passed Resolution R-2005-933 affirming that the City had authorized Messrs. Turner, Levitt and Dahlberg of Kroll to act as the City's duly authorized Audit Committee and to execute the function of an audit committee as contemplated under the Sarbanes-Oxley Act. In that role, we understand that Messrs. Turner, Levitt and Dahlberg (collectively, the "Audit Committee") were authorized to evaluate the status of the City's pending multiple investigations and determine the most effective method of completing an investigation sufficient for the circumstances, including retaining independent counsel and conducting any additional procedures it deemed necessary to complete the needed investigation.



The Honorable Dick Murphy, Mayor
Honorable Members of the City Council
City of San Diego

Mr. Lynn Turner
Mr. Arthur Levitt
Mr. Troy Dahlberg
Kroll Associates, Inc., in its capacity as the
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April 29, 2005
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We are also aware of, and have reviewed, the letter sent by Michael Aguirre, City Attorney, on April 21, 2005, to Mr. Dahlberg, in which Mr. Aguirre takes the position that the Audit Committee does not have the legal authority to retain independent counsel to assist it in the performance of its duties without the express approval of the City Council. Despite the position of the Audit Committee that it requires the assistance of independent counsel, Mr. Aguirre has stated his opinion that the Audit Committee has no need for independent legal assistance or advice. We understand that the issue of the Audit Committee's authority to retain independent counsel will come before the City Council in an upcoming meeting.

It is our view that by enacting Resolution R-2005-933, the City Council appointed, authorized and empowered Messrs. Turner, Levitt and Dahlberg, to act as members of the Audit Committee and to exercise the powers normally exercised by such a committee in these circumstances consistent with the Sarbanes-Oxley Act and the federal securities laws, rules and regulations. In these circumstances, KPMG, as independent auditor, would normally look to such an audit committee to oversee and direct the conduct of the client's investigation (here multiple investigations) of potential illegal acts, determine when sufficient investigative procedures have been completed to adequately address all relevant issues, review the investigator(s) factual findings and legal conclusions and determine what, if any, remedial actions are necessary and/or appropriate and cause (or recommend to the board of directors or equivalent body, here the City Council, that it cause) such remedial actions to be taken. We understand that the City Council's resolution was intended to empower the Audit Committee with the authority it needs to fulfill these functions, and reflects the Council's commitment to the completion of an independent, complete and objective investigative process. KPMG viewed the Council's enactment of Resolution R-2005-933 and the retention of Messrs. Turner, Levitt and Dahlberg as a very positive step toward resolution of the issues presently obstructing completion of our financial statement audit.

KPMG believes that it is important to the resolution of the outstanding issues that the City Council authorize, to the extent it has not already done so, Messrs. Turner, Levitt and Dahlberg, as the duly constituted Audit Committee of the City, to take any and all actions they deem necessary or appropriate to satisfy their obligations under the terms of their retention by the City of San Diego, including the retention and payment of independent legal counsel and/or any other expert or consultant they deem necessary to the completion of the Audit Committee's mandate. We believe any action by the City or any of its officials limiting the Audit Committee's ability to timely or completely execute its obligations could raise serious concerns about when, if at all, KPMG would be in a position to complete its audit procedures and issue an audit report.



The Honorable Dick Murphy, Mayor
Honorable Members of the City Council
City of San Diego

Mr. Lynn Turner
Mr. Arthur Levitt
Mr. Troy Dahlberg
Kroll Associates, Inc., in its capacity as the
Audit Committee of the City of San Diego
April 29, 2005
Page 3

We are hopeful that the City Council will continue to support the authority of the Audit Committee to take whatever actions it deems necessary to conclude an appropriate investigation(s), make detailed factual findings and legal conclusions, and recommend appropriate remedial actions, should that be necessary. As we have previously informed the City, in the event KPMG concludes that the City cannot conduct a thorough and independent investigation, or concludes that any aspect of the investigation is inadequate for our audit purposes, KPMG may modify its audit report or withdraw from the engagement.

Very truly yours,

KPMG LLP

A handwritten signature in black ink that reads 'Steven G. DeVetter'. The signature is written in a cursive, flowing style.

Steven G. DeVetter
Partner

cc: Michael Aguirre, City Attorney
Paul Maco, Esq.



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55 Second Street
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August 5, 2005

The Honorable Toni Atkins, Deputy Mayor
Honorable Members of the City Council
City of San Diego

Kroll Associates, Inc., in its capacity as the
Audit Committee of the City of San Diego

Re: City of San Diego Fiscal Year 2003 Financial Statement Audit – Status Update

Dear Ladies and Gentlemen:

We have been asked for an update on the status of our audit. While we have provided regular weekly status updates to City staff, the purpose of this letter is to update the Council on the key areas and issues that KPMG is currently addressing, as well as our ongoing procedures.

As you know, on April 13, 2004, KPMG was engaged to report upon our audit of the financial statements of the City of San Diego (City) as of and for the year ended June 30, 2003. We are conducting that audit in accordance with auditing standards generally accepted in the United States of America and the standards for financial audits contained in *Government Auditing Standards*.

This letter is subject to the terms of our April 13, 2004 engagement letter, which specifically provides that KPMG must consent to the public dissemination of information pertaining to its services. This letter includes confidential information concerning the status of the City's audit, but based on the specific request of the City's staff, we hereby consent to the public dissemination of this letter.

The City's Investigation of Potential Illegal Acts

When we were engaged by the City, we understood that the City had retained the law firm of Vinson & Elkins (V&E) to conduct an independent investigation of the City's disclosures relating to pension matters and certain other matters. The City agreed to provide complete and unrestricted access to the investigation and agreed that KPMG would, in its sole discretion, determine when the investigation, the investigative report, and any remedial actions were sufficient in the exercise of our professional judgment to allow us to complete our audit.



The Honorable Toni Atkins, Deputy Mayor
Honorable Members of the City Council
City of San Diego
August 5, 2005
Page 2

KPMG had discussions with the City and V&E promptly upon our engagement and provided feedback to City staff and the V&E investigators concerning our views of the sufficiency of the investigation beginning on May 7, 2004. We continued to discuss our views with the City on numerous occasions thereafter. We also supplemented our discussions with written communications starting on August 9, 2004. We understand that these written communications have been provided to the Council so we will not repeat them here. However, it is fair to say that throughout these communications we have shared our concerns regarding the critical importance of independent oversight of the investigation.

As discussed in our April 29, 2005 letter (attached), KPMG viewed the Council's enactment of Resolution R-2005-933 and the retention of Messrs. Turner, Levitt and Dahlberg to function as the City's Audit Committee as a very positive step toward achieving the independent oversight for which we had been pressing and the resolution of the issues obstructing completion of our financial statement audit. We reiterate our belief that it is imperative to the resolution of the outstanding issues that the City Council continue to authorize Messrs. Turner, Levitt and Dahlberg to take any and all actions they deem necessary or appropriate to satisfy their obligations under the terms of their retention by the City of San Diego.

We would view any action by the City or any of its officials to limit the Audit Committee's ability to execute its obligations in a timely and complete manner as reflecting either an inability or unwillingness on the City's part to complete the independent and thorough investigation that is necessary. We believe such actions would also effectively prevent us from completing the audit.

To facilitate a timely review of the investigation and its results, KPMG has been working closely with the Audit Committee in order to help ensure that the investigation, when complete, is consistent with professional standards and sufficient for audit purposes. Our work has included meeting with the Audit Committee, attending certain interviews conducted by investigators, reading documents, reading emails, understanding methodologies, and understanding the level of documentation supporting the investigation. On a positive note, we have observed more progress toward the completion of an independent and thorough investigation in the past three months than in the entire preceding twelve months.

Our understanding is that one of the largest obstacles facing the Audit Committee is access to information at SDCERS which has not been provided to investigators due to a claim of attorney-client privilege. From the outset, we have made it clear to City that the investigation must include SDCERS. We agree with the Audit Committee's need for access to SDCERS information, and would view the continued assertion of attorney-client privilege as blocking the investigators access to necessary information and creating a scope restriction on the City's investigation which would prevent us from completing the audit.

The Honorable Toni Atkins, Deputy Mayor
Honorable Members of the City Council
City of San Diego
August 5, 2005
Page 3

The City's Financial Statements

The City will be required and has agreed to make representations to KPMG when they believe the City's 2003 financial statements are complete and prepared consistent with generally accepted accounting principles. Due to questions on the City's financial statements raised by KPMG, City staff and Macias Gini (the auditors conducting the audit of the City's 2004 financial statements), the City has not yet concluded that the 2003 financial statements are complete and prepared consistent with generally accepted accounting principles.

In addition, the City has already determined that it is necessary to make 30 corrections to lower its June 30, 2002 reported net assets by \$642 million. These adjustments, which affect the opening balances of the June 30, 2003 financial statements (i.e., the financial statements for the year that KPMG is auditing), are due to errors that require restatements in a variety of areas including pension accounting, capital assets of the water and wastewater funds, infrastructure, capital accounting, and revenue recognition. Additionally, these and other issues have resulted in changes to the draft June 30, 2003 financial statements.

KPMG continues to work with the City in addressing the open questions posed by KPMG, City staff and Macias Gini. KPMG is also performing additional work based upon information provided to date by the Audit Committee. For example, the Audit Committee has recommended that a new actuary be retained to issue independent actuarial reports for SDCERS beginning, at least, with the fiscal year ended June 30, 2003. If, upon receipt of an independent actuarial report, there are significant discrepancies in the results, including the unfunded actuarial accrued liability, we and the Audit Committee agree that further work may be required. The new actuarial information will need to be reviewed and evaluated once it is obtained, and the City will need to make decisions on whether additional reports, adjustments, or disclosures are required.

KPMG's Ongoing Procedures

- KPMG will continue to review and evaluate the methodologies, findings, and issues being raised by the investigation and will also review and evaluate the decisions to be made regarding the appropriateness of the remedial actions taken.
- KPMG will evaluate what additional audit procedures might be required as a result of the investigation.
- KPMG will evaluate what additional disclosures might be required as a result of the investigation.
- KPMG will continue to work with the City in addressing the open questions raised by KPMG, City staff and Macias Gini.
- KPMG will review subsequent events to evaluate whether issues occurring before June 30, 2003 have been properly reflected or disclosed in the June 30, 2003 financial statements and

The Honorable Toni Atkins, Deputy Mayor
Honorable Members of the City Council
City of San Diego
August 5, 2005
Page 4

whether significant items occurring after June 30, 2003 are being properly disclosed in the 2003 financial statements.

Compensation and Timing

Through July 31, 2005, KPMG has billed the City \$2,638,977 for its professional fees and out-of-pocket expenses.

With each semi-monthly bill, KPMG has provided the City with the detail of the hours and expenses of each individual working on the engagement.

KPMG's fees and expenses for the first seven (7) months of 2005 have averaged \$121,000 per month. Based upon our understanding of the issues today, we estimate similar billings to continue until the City is in a position to complete its work in preparing the 2003 financial statements; the necessary independent investigation is completed; appropriate remedial action has been taken; and we have been able to complete the audit procedures required in our judgment to meet professional standards for the issuance of an audit report on the City's financial statements.

Very truly yours,

KPMG LLP



Steven G. DeVetter
Partner

cc: Mr. Michael Aguirre, City Attorney



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September 22, 2005

The Honorable Toni Atkins, Acting Mayor
Honorable Members of the City Council
City of San Diego

Kroll Associates, Inc., in its capacity as the
Audit Committee of the City of San Diego

Re: City of San Diego Fiscal Year 2003 Financial Statement Audit – Status Update

Dear Ladies and Gentlemen:

We have been asked for an update on the status of our audit. While we have provided regular status updates to City staff, the purpose of this letter is to update the Council on the key areas and issues that KPMG is currently addressing, as well as our ongoing procedures.

On April 13, 2004, KPMG was engaged to report upon our audit of the financial statements of the City of San Diego (City) as of and for the year ended June 30, 2003. We are conducting that audit in accordance with auditing standards generally accepted in the United States of America and the standards for financial audits contained in *Government Auditing Standards*.

This letter is subject to the terms of our April 13, 2004 engagement letter, which specifically provides that KPMG must consent to the public dissemination of information pertaining to its services. This letter includes confidential information concerning the status of the City's audit, but based on the specific request of the City's staff, we hereby consent to the public dissemination of this letter.

The City's Investigation of Potential Illegal Acts

When engaged by the City, we understood that the City retained legal counsel to conduct an independent investigation of the City's disclosures relating to pension matters and certain other matters. The City agreed to provide complete and unrestricted access to the investigation and agreed that KPMG would determine when the investigation or any aspect thereof was sufficient to allow us to complete our audit.

KPMG views the Council's enactment of Resolution R-2005-933 and the retention of Messrs. Turner, Levitt and Dahlberg as a very positive step toward completion of an independent investigation. KPMG continues to believe that it is important to the completion of the independent investigation that Messrs. Turner, Levitt and Dahlberg continue to take any and all



The Honorable Toni Atkins, Acting Mayor
Honorable Members of the City Council
City of San Diego
September 22, 2005
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actions they deem necessary or appropriate to satisfy their obligations under the terms of their retention by the City of San Diego.

To facilitate a timely review of the investigation, KPMG has been working closely with the Audit Committee in order to help ensure that the investigation, when complete, is consistent with professional standards and sufficient for audit purposes. Such work has included attending interviews conducted by investigators, reviewing documents, reviewing emails, reviewing methodologies, and reviewing the level of documentation supporting the investigation. As investigation activity increases in the next several months, we anticipate our efforts in the area will also increase.

As we have previously discussed with the City, the independent investigation must encompass the San Diego City Employee Retirement System (“SDCERS”). Our understanding is that the Audit Committee is actively investigating activities occurring within SDCERS. We also understand that the Board of Administration has announced that it has hired Navigant Consulting, Inc. to provide certain investigative services that may relate to the matters being investigated by the Audit Committee.

We plan to continue to work with the Audit Committee to understand all of the procedures it is performing relating to this investigation, including such procedures that may be required relating to the newly provided SDCERS documents and the implications for the Audit Committee’s investigation of the investigative work that SDCERS has apparently retained Navigant to perform.

The City’s Financial Statements

The City has agreed to make representation to KPMG when they believe the City’s 2003 financial statements are complete and prepared consistent with Generally Accepted Accounting Principles. Due to questions raised by KPMG, City staff, and the auditors of the 2004 financial statements, the City has not yet concluded that the 2003 financial statements are complete and prepared consistent with Generally Accepted Accounting Principles.

We have been working with City staff on open items and developing timelines for providing the necessary information to KPMG over the next several months. KPMG is also performing additional work based upon information provided to date by the Audit Committee and other auditors.



The Honorable Toni Atkins, Acting Mayor
Honorable Members of the City Council
City of San Diego
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KPMG's Ongoing Procedures

- KPMG will continue to review the methodologies, findings, and issues being raised by the investigation, and will review the decisions made regarding the appropriateness of the remedial actions taken.
- KPMG will evaluate what additional audit procedures might be required as a result of the investigation.
- KPMG will evaluate what additional disclosures might be required as a result of the investigation.
- KPMG will continue to work with the City in addressing the open questions of KPMG, City staff and Macias Gini (the auditors conducting the audits of the City's 2004 and 2005 financial statements)
- KPMG will review subsequent events to evaluate whether issues occurring before June 30, 2003 have been properly reflected or disclosed in the June 30, 2003 financial statements and whether significant items occurring after June 30, 2003 are being properly disclosed in the 2003 financial statements.

Compensation and Timing

Through September 15, 2005, KPMG has billed the City \$2,794,107 for its professional fees and out-of-pocket expenses.

With each semi-monthly bill, KPMG has provided the City with the detail of the hours and expenses of each individual working on the engagement.

Although several issues remain to be resolved, it is not possible to state when an audit opinion, if any, will be issued. However, we are committed to working with the City to complete this audit as soon as practical.

Very truly yours,

KPMG LLP

Steven G. DeVetter
Partner

cc: Mr. Michael Aguirre, City Attorney



KPMG LLP
55 Second Street
San Francisco, CA 94105

Telephone 415 963 5100
Fax 415 963 8100
Internet www.us.kpmg.com

December 1, 2006

The Honorable Jerry Sanders, Mayor
Honorable Members of the City Council
City of San Diego

Re: City of San Diego Fiscal Year 2003 Financial Statement Audit – Status Update

Dear Mayor Sanders and Members of the City Council:

We have been asked for an update on the status of our audit. While we have provided regular status updates to City staff, the purpose of this letter is to update the Council on the key areas and issues that KPMG is currently addressing, as well as our ongoing procedures.

As you know, on April 13, 2004, KPMG was engaged to report upon our audit of the financial statements of the City of San Diego (City) as of and for the year ended June 30, 2003. We are conducting that audit in accordance with auditing standards generally accepted in the United States of America and the standards for financial audits contained in *Government Auditing Standards*.

This letter is subject to the terms of our April 13, 2004 engagement letter, which specifically provides that KPMG must consent to the public dissemination of information pertaining to its services. This letter includes confidential information concerning the status of the City's audit, but based on the specific request of the City's staff, we hereby consent to the public dissemination of this letter.

The City's Financial Statements

The City, through its staff, has agreed to make a representation to KPMG when the staff believes the City's 2003 financial statements are complete and prepared consistent with Generally Accepted Accounting Principles. Due to questions raised by KPMG, City staff, and the auditors of the 2004 financial statements, the City has not yet concluded that the 2003 financial statements are complete and prepared consistent with Generally Accepted Accounting Principles.

We have been working with City staff on open items and developing timelines for providing the necessary information to KPMG.



The Honorable Jerry Sanders, Mayor
Honorable Members of the City Council
City of San Diego
December 1, 2006
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KPMG's Ongoing Procedures

To provide you with a sense of the process, following are some of the key items necessary for us to complete the audit.

- 1 Receiving an updated draft of the Comprehensive Annual Financial Report (CAFR) on December 1, 2006, along with a black-lined version so we can focus on the changes from previous versions,
- 2 Receiving support for and applying appropriate auditing procedures to the recent \$154 million capitalized interest adjustment for activity going back over a decade,
- 3 Receiving and reviewing management's responses to Councilmember Frye's October 16, 2006 questions,
- 4 Receiving the final audited financial statements and the related auditor letter for the San Diego Housing Commission,
- 5 Receiving and applying appropriate auditing procedures to the "restatement binder" which is comprehensive documentation of each item discussed in footnote 23, "restatements,"
- 6 Receiving support for and applying appropriate auditing procedures to the recent \$134 million DROP liability and related activity adjustments,
- 7 Receiving the management representation letter signed by City and SDCERS management, as well as receiving an updated letter from the audit committee regarding the investigation,
- 8 Applying appropriate auditing procedures to the City's response to assertions raised recently by a former employee,
- 9 Reviewing the resolution of 93 CAFR comments previously raised by KPMG's quality control partner, and
- 10 Receiving and applying appropriate auditing procedures to the remaining detail items on our "master pending list."

Compensation and Timing

Through November 15, 2006, KPMG has billed the City \$6,192,079 for its professional fees and out-of-pocket expenses.

With each semi-monthly bill, KPMG has provided the City with the detail of the hours and expenses of each professional working on the engagement.



The Honorable Jerry Sanders, Mayor
Honorable Members of the City Council
City of San Diego
December 1, 2006
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We have recently been provided an updated CAFR and several items requested to support the City financial statements, with additional items still pending as discussed above. We have discussed with City staff a plan that anticipates:

- Having all open items provided by the City to KPMG by December 8, 2006, except the restatement binder which is due December 12, 2006,
- Having the KPMG team analyze and perform audit procedures as appropriate with respect to this information by December 15, 2006, and
- Completing our quality control reviews by December 22, 2006.

We anticipate that timely completion of these matters should enable us to complete our audit and issue our opinion by December 22, 2006. We also expect this plan will result in an additional \$300,000 to \$400,000 of effort beyond the \$6.2 million noted above. Although a number of open items could affect this schedule and the estimate of additional expense, we are committed to working with the City to complete this audit as soon as practical.

Very truly yours,

KPMG LLP

A handwritten signature in black ink that reads 'Steven G. DeVetter'.

Steven G. DeVetter
Partner

cc: Michael Aguirre, City Attorney



JERRY SANDERS
MAYOR

March 12, 2007

KPMG LLP
55 Second Street
San Francisco, CA 94105

Ladies and Gentlemen:

We are providing this letter in connection with your audit of the basic financial statements of the City of San Diego, California, as of and for the year ended June 30, 2003, for the purpose of expressing opinions as to whether the basic financial statements present fairly, in all material respects, the financial position 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), and the respective changes in financial position and cash flows, where applicable, in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the basic financial statements of financial position, changes in financial position, and cash flows in conformity with accounting principles generally accepted in the United States of America. We are also responsible for establishing and maintaining effective internal control over financial reporting.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, the following representations made to you during your audit:

1. The basic financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.
2. We have made available to you:
 - a. All financial records and related data.
 - b. All minutes of the meetings of the City Council and the Board of Administration of the San Diego City Employees' Retirement System, or summaries of actions of recent meetings for which minutes have not yet been prepared.

3. Except as disclosed in the notes to the financial statements, there have been no communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
4. In our January 1, 2006 Annual Report on Internal Controls, we disclosed to you all reportable conditions and all material weaknesses in internal control over financial reporting which could adversely affect the City's ability to record, process, summarize and report financial data.
5. Except as disclosed in the notes to the basic financial statements, there are no:
 - a. Violations or possible violations of laws or regulations that have come to management's attention whose effects are regarded to be significant enough that they need to be considered for disclosure in the basic financial statements or as a basis for recording a loss contingency.
 - b. Unasserted claims or assessments that our lawyers have advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*.
 - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by SFAS No. 5. We understand that a gain or loss contingency refers to an existing condition or set of circumstances involving uncertainty as to possible gain or loss that will be resolved in the future by the occurrence, or lack of occurrence, of one or more events. Resolution of the uncertainty may confirm the loss or impairment of an asset, the incurrence of a liability, the acquisition of an asset, or the reduction of a liability. Such contingencies do not include the normal accounting estimates required in the basic financial statements for the ongoing and recurring activities of the City such as accruals for utility expenses and depreciation of capital assets.
 - d. Material transactions, for example, grants or encumbrances, that have not been properly recorded in the accounting records underlying the basic financial statements.
 - e. Events that have occurred subsequent to the date of the statement of net assets and through the date of this letter that would require adjustments to or disclosure in the basic financial statements.
6. The schedule of uncorrected financial statement misstatements contains no items.

7. The City has no:
 - a. Commitments for the purchase or sale of services or assets at prices involving material probable loss.
 - b. Material amounts of obsolete, damaged, or unusable items included in the inventories at greater than salvage values.
 - c. Loss to be sustained as a result of other-than-temporary declines in the fair value of investments.
8. The City has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
9. Capital assets, including infrastructure assets, are properly capitalized, reported and, if applicable, depreciated. There are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
10. Deposits and investment securities are properly classified and reported.
11. Pension matters are properly classified and reported.
12. Information contained in Note 23, restatements, is accurate, complete, and includes all necessary corrections to reported June 30, 2002 net assets and fund balances.
13. The City is responsible for the identification of and compliance with all aspects of laws, regulations, contracts, or grants that could have a material effect on the basic financial statement amounts in the event of noncompliance including legal and contractual provisions for reporting specific activities in separate funds and has disclosed those aspects of laws, regulations, contracts, or grants to you.
14. Except as disclosed in the notes to the basic financial statements, the City has complied, in all material respects, with applicable laws, regulations, contracts and grants that could have a material effect on the basic financial statements in the event of noncompliance.
15. The following have been properly recorded or disclosed in the basic financial statements:
 - a. Related party transactions including sales, purchases, loans, transfers, leasing arrangements, guarantees, ongoing contractual commitments and amounts receivable from or payable to related parties. We understand that the term "related party" refers to affiliates of the City; entities for which investments are accounted for by the equity method by the City; trusts for the benefit of

employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; key administrative, financial, and legislative personnel and other members of City management or businesses they represent or have an interest in; members of the immediate families of City management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

- b. Guarantees, whether written or oral, under which the City is contingently liable.
 - c. Arrangements with financial institutions involving compensating balances, or other arrangements involving restrictions on cash balances and lines of credit or similar arrangements.
 - d. Agreements to repurchase assets previously sold, including sales with recourse.
 - e. Changes in accounting principle affecting consistency.
 - f. The existence of and transactions with joint ventures and other related organizations.
16. The City has identified and properly accounted for all nonexchange transactions.
17. The following information about financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk has been properly disclosed in the basic financial statements:
- a. Extent, nature, and terms of financial instruments with off-balance-sheet risk;
 - b. The amount of credit risk of financial instruments with off-balance-sheet credit risk and information about the collateral supporting such financial instruments; and
 - c. Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments.

18. Provision has been made for any material loss that is probable from environmental remediation liabilities associated with the Miramar Landfill site. We believe that such estimate is reasonable based on available information and that the liabilities and related loss contingencies and the expected outcome of uncertainties have been adequately disclosed in the City's basic financial statements.
19. The City's reporting entity includes all entities that are component units of the City. Such component units have been properly presented as either blended or discrete. Investments in joint ventures in which the City holds an equity interest have been properly recorded on the statement of net assets. The basic financial statements disclose all other joint ventures and other related organizations.
20. The basic financial statements properly classify all funds and activities.
21. Net asset components (invested in capital assets, net of related debt; restricted; and unrestricted) and fund balance reserves and designations are properly classified and, if applicable, approved.
22. Except as disclosed in the notes to the basic financial statements, the City has complied with all tax and debt limits and with all debt related covenants.
23. The City has presented all required supplementary information. This information has been measured and prepared within prescribed guidelines.
24. The City has complied with all applicable laws and regulations in adopting, approving and amending budgets.
25. We acknowledge our responsibility for the design and implementation of programs and controls to prevent, deter and detect fraud. We understand that the term "fraud" includes misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.

Misstatements arising from fraudulent financial reporting are intentional misstatements, or omissions of amounts or disclosures in financial statements to deceive financial statement users. Misstatements arising from misappropriation of assets involve the theft of an entity's assets where the effect of the theft causes the basic financial statements not to be presented in conformity with accounting principles generally accepted in the United States of America.

26. Except as disclosed in the basic financial statements, we have no knowledge of any fraud or suspected fraud affecting the entity involving:

- a. Management,
 - b. Employees who have significant roles in internal control over financial reporting, or
 - c. Others where the fraud could have a material effect on the basic financial statements.
27. Except as disclosed in the basic financial statements, we have no knowledge of any allegations of fraud or suspected fraud affecting the City received in communications from employees, former employees, analysts, regulators, or others.
 28. We have no knowledge of any officer or member of the City Council, or any other person acting under the direction thereof, taking any action to fraudulently influence, coerce, manipulate or mislead you during your audit.
 29. The City has not elected to apply the option allowed in paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Activities*, to its proprietary funds.
 30. We have received opinions of counsel upon each issuance of tax-exempt bonds that the interest on such bonds is exempt from federal income taxes under the Internal Revenue Code of 1986, as amended. There have been no changes in the use of property financed with the proceeds of tax-exempt bonds, or any other occurrences, subsequent to the issuance of such opinions, that would jeopardize the tax-exempt status of the bonds. Provision has been made, where material, for the amount of any required arbitrage rebate.
 31. Receivables reported in the basic financial statements represent valid claims against debtors arising on or before the date of the statement of net assets and have been appropriately reduced to their estimated net realizable value.
 32. The City is responsible for determining the fair value of certain investments as required by GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. The amounts reported represent the City's best estimate of fair value of investments required to be reported under the Statement. The City also has disclosed the methods and significant assumptions used to estimate the fair value of its investments, and the nature of investments reported at amortized cost.
 33. All funds that meet the quantitative criteria in GASB Statement No. 34 for presentation as major are identified and presented as such, and all other funds that are presented as

major are considered to be particularly important to financial statement users by management.

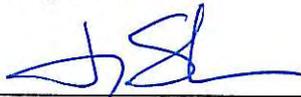
34. Expenses have been appropriately classified in or allocated to functions and programs in the statement of activities, and allocations have been made on a reasonable basis.
35. Revenues are appropriately classified in the statement of activities within program revenues, general revenues, contributions to term or permanent endowments, or contributions to permanent fund principal.
36. Interfund, internal and intra-entity activity and balances have been appropriately classified and reported.
37. Special and extraordinary items are appropriately classified and reported.
38. The self insurance internal service fund has a deficit at June 30, 2003. The total charge by the internal service fund to other funds is based on an actuarial method or historical cost information and adjusted over a reasonable period of time so that internal service fund revenues and expenses are approximately equal. Management's plan described in Note 16, Fund Deficit, achieves this objective.
39. The City has identified and made the appropriate disclosures for all derivative instruments not reported at fair value in the financial statements in accordance with GASB Technical Bulletin 03-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*.
40. We agree with the findings of specialists in evaluating the adequacy of the self-insurance claims liability and have adequately considered the qualifications of the specialist in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give or cause any instructions to be given to specialists with respect to the values or amounts derived in an attempt to bias their work, and we are not otherwise aware of any matters that have had an impact on the independence or objectivity of the specialists.
41. We believe that the actuarial assumptions and methods used to measure pension liabilities and costs for financial accounting and disclosure purposes are appropriate in the circumstances.
42. In accordance with Government Auditing Standards, we have identified to you the significant findings and recommendations from previous financial audits, attestation engagements, performance audits, or other studies related to the objectives of this audit

and have accurately communicated to you the related corrective actions taken to address the findings.

43. We confirm that all relevant information relating to the facts and circumstances, which are the subject of the Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure conducted by Kroll and Willkie Farr & Gallagher LLP have been disclosed by us to the Audit Committee, to the investigating team, and to you. We also confirm that, where necessary, we have taken, or are taking, timely and appropriate remedial action. *The individuals signing this letter are not subject to a Wells notice by the SEC and have no reason to believe that they are the subject of any investigation by the Department of Justice or the Securities and Exchange Commission.*
44. We confirm that that information contained in Note 18, Contingencies, regarding the Securities and Exchange Commission (SEC) Order sanctioning the City is complete and accurate. Further, we are complying with all terms of that Order.
45. We acknowledge that KPMG must be independent in the performance of its audit. Accordingly, we represent that the City has no present intention to commence litigation against KPMG.

Very truly yours,

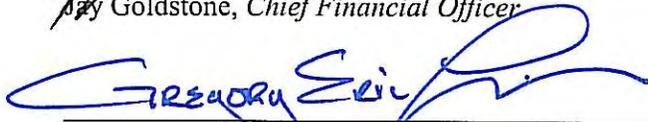
City of San Diego, California



Jerry Sanders, *Mayor*



Jay Goldstone, *Chief Financial Officer*



Greg Levin, *Acting Deputy Comptroller*



March 16, 2007

KPMG LLP
55 Second Street
San Francisco, CA 94105

Ladies and Gentlemen:

We are providing this letter in connection with your audit of the basic financial statements of the City of San Diego, California, as of and for the year ended June 30, 2003, for the purpose of expressing opinions as to whether the basic financial statements present fairly, in all material respects, the financial position 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), and the respective changes in financial position and cash flows, where applicable, in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation of San Diego City Employees' Retirement System (SDCERS) matters in the City's basic financial statements of financial position, changes in financial position, and cash flows in conformity with U.S. generally accepted accounting principles. We are also responsible for establishing and maintaining effective internal control over financial reporting at SDCERS.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, the following representations made to you during your audit:

1. The portions of the City's basic financial statements referred to above that specifically refer or relate to SDCERS are fairly presented in conformity with U.S. generally accepted accounting principles.
2. We have made available to you:
 - a. All financial records and related data necessary for an audit.
 - b. All minutes of the meetings of the Board of Administration of the San Diego City Employees' Retirement System, or summaries of actions of recent meetings for which minutes have not yet been prepared.

KPMG LLP
March 16, 2007
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3. Except as disclosed in the notes to the City's financial statements, there have been no communications from regulatory agencies to SDCERS concerning noncompliance with, or deficiencies in, financial reporting practices.
4. Except as it may relate to the restatements reported in the City's financial statements, there are no reportable conditions in the design or operation of internal control over financial reporting which could adversely affect SDCERS' ability to record, process, summarize and report financial data.
5. Except as disclosed in the notes to the basic financial statements, as it relates to SDCERS matters, there are no:
 - a. Violations or possible violations of laws or regulations that have come to management's attention whose effects are regarded to be significant enough that they need to be considered for disclosure in the basic financial statements or as a basis for recording a loss contingency.
 - b. Unasserted claims or assessments that our lawyers have advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*.
 - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by SFAS No. 5. We understand that a gain or loss contingency refers to an existing condition or set of circumstances involving uncertainty as to possible gain or loss that will be resolved in the future by the occurrence, or lack of occurrence, of one or more events. Resolution of the uncertainty may confirm the loss or impairment of an asset, the incurrence of a liability, the acquisition of an asset, or the reduction of a liability. Such contingencies do not include the normal accounting estimates required in the basic financial statements for the ongoing and recurring activities of SDCERS such as accruals for utility expenses and depreciation of capital assets.
 - d. Material transactions, for example, grants or encumbrances, that have not been properly recorded in the accounting records underlying the basic financial statements.
 - e. Events that have occurred subsequent to the date of the statement of net assets and through the date of this letter that would require adjustments to or disclosure in the City's basic financial statements.
6. Summaries of disclosures made in the SDCERS draft June 30, 2004 CAFR that constitute either additional disclosures to those set forth in the notes to the City's basic financial statements or provide greater detail to that set forth in the notes to the City's basic financial statements are as follows:

KPMG LLP
March 16, 2007
Page 3

The City of San Diego's Pension Reform Commission (PRC) made various recommendations to the City Council in its September 2004 report. Two recommendations required amending the City Charter, which requires a vote of the citizens of the City of San Diego. Accordingly, two ballot measures – Propositions G and H – were put before the voters in the November 2, 2004 City of San Diego General Election. Both passed.

Proposition G adds language into the City Charter which, beginning July 1, 2008 (FY 2009), sets amortization schedules recommended by the PRC for SDCERS' Board and the City to use in making the calculations necessary to determine the component of the City's annual contribution associated with paying down the Unfunded Actuarial Accrued Liability (UAAL). In addition, this measure adds language into the City Charter that precludes the City and SDCERS' Board from entering into any future multi-year contracts or agreements delaying full funding of City's contribution obligations to SDCERS, except for court-approved settlement agreements. Proposition G passed receiving 53.5% of the vote.

In October 2005, the California Attorney General issued opinion No. 04-710, 88 Op. Atty Gen. Cal 165. In response to a question from Assemblyman Jerome Horton, the Attorney General concluded that a city charter may not require a city employees' retirement board to place the cost of the past service liability associated with a new retirement benefit on a specified amortization schedule or place the cost associated with net accumulated actuarial gains and losses on a time specific amortization schedule.

Proposition H changed the term of office of SDCERS' Board Members from six to four years, and changed the composition of the Board as follows: seven citizens with professional qualifications appointed by the Mayor and confirmed by the City Council; two employee members elected by active general member employees; one member elected by City retirees; one employee member elected by active members from Fire Safety, one employee member elected by active members from Police Safety, and one City management employee appointed from the administrative service of the City. Prior to Proposition H, a majority of the Board were employees of the City (including representatives from labor and management).

Proposition H also requires that the seven citizen appointees to the Board have a college degree in finance, economics, law, business, or other relevant field of study, or a relevant professional certification. Additionally, a citizen appointee must have a minimum of 15 years experience in pension administration, pension actuarial practice, investment management, real estate, banking, or accounting. To prevent conflicts of interest, the measure provides that "no person who is a City employee or participant in SDCERS or a City union representative may be eligible for appointment in this category." Also, "appointees shall not have any other personal interest which would create a conflict of interest with the duties of a Board member and trustee." Proposition H passed with 64.6% of the vote.

KPMG LLP
March 16, 2007
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The City Attorney filed a civil action on behalf of the People of the State of California against SDCERS' former Retirement Administrator Lawrence B. Grissom, General Counsel Loraine Chapin, and certain former SDCERS' Board members. The action seeks monetary penalties, an order setting aside specified Board actions, injunctive relief, costs and attorneys' fees for alleged violations of the Political Reform Act of 1974, as amended. Mr. Grissom, Ms. Chapin and former trustees Ron Saathoff and Teri Webster, remain as defendants in the lawsuit. SDCERS is not a party to the litigation, but has agreed to pay the legal expenses of Ms. Chapin and Mr. Grissom.

SDCERS filed a Complaint for legal malpractice and breach of fiduciary duty against its former fiduciary counsel for actions and advice involving the Board's adoption of Manager's Proposal 2. The matter settled and SDCERS recovered approximately \$11,000,000, net of attorney's fees, in September 2005.

On August 16, 2005, the City of San Diego filed a Complaint for Damages against SDCERS' investment consultant and actuary for professional negligence, intentional fraud-affirmative misrepresentation and intentional fraud-concealment. SDCERS is not a party to this case.

On July 12, 2005, SDCERS filed with the Internal Revenue Service (IRS) an application for a Tax Determination Letter (TDL), and a request for a compliance statement from the IRS under the Voluntary Correction Program (VCP). Ice Miller LLP is representing SDCERS before the IRS. The initial VCP filing addressed a correction to the City's Presidential Leave Program for presidents of certain labor organizations that represent City employees. Since that time, additional VCP filings have been made concerning compensation limits under Internal Revenue Code (IRC) section 401(a)(17); minimum distribution requirements under section 401(a)(9); distribution rollover compliance under section 401(a)(31); the DROP program; disability benefit overpayments; cashless leave/purchase of service credits; post employment health benefits and health administrative expenses under section 401(h); and benefit and compensation limits under sections 401(b), 401(c) and 401(n). All filings were made by the end of August 2006.

In its filings, SDCERS is proposing to seek recovery from the City for the following amounts: (1) \$31,618,356 for retiree medical benefits paid from the SDCERS Trust Fund per City Ordinance between 1982 and 1991 (\$8,227,271 for benefits, plus \$23,391,085 in interest through fiscal year 2006), (2) \$2,211,895 for unreimbursed costs of administering the retiree medical benefit between 1982 and July 1, 2006 (\$1,523,431 for administration costs, plus \$688,464 in interest through fiscal year 2006), and (3) \$577,452 for the past use of Annual Leave to Purchase Service Credit.

KPMG LLP
March 16, 2007
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SDCERS position is that no penalties should be imposed for any compliance failures. Although this is a reasonable position, we cannot predict whether it will be accepted by the IRS. However, SDCERS does not anticipate any material adverse financial impact on SDCERS from the IRS filings.

On August 30, 2005, SDCERS' Board unanimously approved the retention of Navigant Consulting Inc, through its special fiduciary counsel Reish Luftman Reicher & Cohen, to conduct an independent investigation into allegations of wrongdoing by the city and SDCERS.

Navigant issued its report to the Board on January 20, 2006. A copy of which is available on SDCERS' web site at http://www.sdcers.org/forms_newsevents.jsp. Navigant's Report concluded that there had been a breach of fiduciary duty by former SDCERS Board members approving the 1996 Manager's Proposal and 2002 Contribution Agreement presented by the City. Reish Luftman Reicher & Cohen provided legal analysis of Navigant's findings and concluded that approval of these agreements also violated state and municipal law. Finally, the Navigant Report concluded that the payment of certain benefits using Trust Fund assets including administration costs of retiree health care, Corbett Settlement provisions, and Presidential Leave benefits, had violated Internal Revenue Code rules, jeopardizing the Trust Fund's tax exempt status.

The Navigant Report recommended changes to SDCERS in governance and oversight, actuarial soundness, tax compliance, training and education, and SDCERS' independence from the City. In response to Navigant's findings and recommendations, the Board established an ad hoc committee to recommend appropriate reform actions to the Board for approval and implementation. The Navigant Report Committee met monthly from February to August 2006 to review the findings and major issues. Its Final Report was issued on December 15, 2006. As a result of the Navigant Report Committee meetings, the Board established a new committee structure including a Business and Governance Committee as well as an Audit Committee comprised of two board members and three outside, independent members. The Board created an internal audit position to report directly to the Audit Committee and established a Compliance Officer position, which reports directly to the Board of Administration.

7. SDCERS has no:
 - a. Commitments for the purchase or sale of services or assets at prices involving material probable loss.
 - b. Material amounts of obsolete, damaged, or unusable items included in the inventories at greater than salvage values.
 - c. Loss to be sustained as a result of other-than-temporary declines in the fair value of investments.

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8. SDCERS has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
9. SDCERS' capital assets, including infrastructure assets, are properly capitalized, reported and, if applicable, depreciated. There are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
10. SDCERS' deposits and investment securities are properly classified and reported.
11. Pension matters are properly classified and reported.
12. Information contained in Note 23, restatements, as it relates to SDCERS, is accurate, complete, and includes all necessary corrections to reported June 30, 2002 net assets and fund balances.
13. SDCERS is responsible for the identification of and compliance with all aspects of laws, regulations, contracts, or grants governing SDCERS that could have a material effect on the basic financial statement amounts in the event of noncompliance including legal and contractual provisions for reporting specific activities in separate funds and has disclosed those aspects of laws, regulations, contracts, or grants to you.
14. Except as disclosed in the notes to the basic financial statements, SDCERS has complied, in all material respects, with applicable laws, regulations, contracts and grants that could have a material effect on the basic financial statements in the event of noncompliance.
15. Solely as it relates to SDCERS, the following have been properly recorded or disclosed in the City's basic financial statements:
 - a. Related party transactions including sales, purchases, loans, transfers, leasing arrangements, guarantees, ongoing contractual commitments and amounts receivable from or payable to related parties. We understand that the term "related party" refers to affiliates of SDCERS; entities for which investments are accounted for by the equity method by SDCERS; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of SDCERS management; key administrative, financial, and legislative personnel and other members of SDCERS management or businesses they represent or have an interest in; members of the immediate families of SDCERS management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

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- b. Guarantees, whether written or oral, under which SDCERS is contingently liable.
 - c. SDCERS' arrangements with financial institutions involving compensating balances, or other arrangements involving restrictions on cash balances and lines of credit or similar arrangements.
 - d. SDCERS' agreements to repurchase assets previously sold, including sales with recourse.
 - e. Changes in accounting principle affecting consistency.
 - f. The existence of and transactions by SDCERS with joint ventures and other related organizations.
16. SDCERS has identified and properly accounted for all nonexchange transactions.
17. Solely as it relates to SDCERS, the following information about financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk has been properly disclosed in the City's basic financial statements:
- a. Extent, nature, and terms of financial instruments with off-balance-sheet risk;
 - b. The amount of credit risk of financial instruments with off-balance-sheet credit risk and information about the collateral supporting such financial instruments; and
 - c. Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments.
18. Not used.
19. SDCERS' reporting entity includes all entities that are component units of SDCERS. Such component units have been properly presented as either blended or discrete. Investments in joint ventures in which SDCERS holds an equity interest have been properly recorded on the statement of net assets. The basic financial statements disclose all other joint ventures and other related organizations known to SDCERS.
20. The basic financial statements properly classify SDCERS funds and activities.
21. Net asset components (Held in Trust for Pension Benefits and Other Purposes and Held in Trust for Postemployment Healthcare Benefits) and designations are properly classified and, if applicable, approved.

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22. Except as disclosed in the notes to the City's basic financial statements, SDCERS has complied with all tax and debt limits and with all debt related covenants. We have disclosed to you our filings with the Internal Revenue Service with reference to tax limit violations.
23. SDCERS has presented all required supplementary information. This information has been measured and prepared within prescribed guidelines.
24. SDCERS, on the advice of its actuary, intends to adopt amortization schedules for the funding of its current unfunded actuarial accrued liability that may differ from the amortization schedules presently in place and, effective with the June 30, 2007 valuation intends to move from the "Projected Unit Credit" funding method to the "Entry Age Normal" funding method. Also, effective with its June 30, 2006, actuarial valuation, the following methodology changes were made:
 - A move from a "book value based" asset smoothing method to the "expected asset value" smoothing method. For June 30, 2006, the asset value was set to market value as of the same date, with the actual smoothing method commencing in June 30, 2007.
 - The asset apportionment method between SDCERS' three plan sponsors (City of San Diego, Unified Port District, and San Diego County Regional Airport Authority) was changed from an allocation method based on various approximations to one that will directly reflect as of June 30, 2005 and forward, the actual cash flows attributable to each plan sponsor since June 30, 2005.
 - All "contingent" liabilities (Corbett pre-July 1, 2000 retirees and the 13th check) are now reflected in the June 30, 2006 valuation liabilities.
 - SDCERS assets and liabilities as of June 30, 2006 now reflect both the future liabilities for DROP retirements and supplemental COLA as well as the asset reserves held for such liabilities. Previously, both amounts were excluded from SDCERS reported assets and liabilities.
 - All future benefits payable from the SDCERS Trust Fund are capped at the maximum benefit level allowable under Internal Revenue Code Section 415.
 - Benefits and resulting liabilities for current and future disabled participants have been reduced to reflect the legal decision that the Corbett judgment and plan document do not authorize a 10% increase to non-service eligible disability retirees.
 - Minor adjustments in the allocation of liabilities amongst the three plan sponsors were made to ensure that when participants have service with more than one contributing employer the resulting liability allocation is equitably determined.

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25. We acknowledge our responsibility for the design and implementation of programs and controls at SDCERS to prevent, deter and detect fraud. We understand that the term "fraud" includes misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.

Misstatements arising from fraudulent financial reporting are intentional misstatements, or omissions of amounts or disclosures in financial statements to deceive financial statement users. Misstatements arising from misappropriation of assets involve the theft of an entity's assets where the effect of the theft causes the basic financial statements not to be presented in conformity with U.S. generally accepted accounting principles.

26. Except as disclosed in the City's basic financial statements and as described in this letter, we have no knowledge of any fraud or suspected fraud affecting the entity involving:
- a. Management,
 - b. Employees who have significant roles in internal control over financial reporting, or
 - c. Others where the fraud could have a material effect on the City's basic financial statements.
27. Except as disclosed in the City's basic financial statements and as described in this letter, we have no knowledge of any allegations of fraud or suspected fraud affecting SDCERS received in communications from employees, former employees, analysts, regulators, or others.
28. We have no knowledge of any officer or member of the SDCERS Board of Administration, or any other person acting under the direction thereof, taking any action to fraudulently influence, coerce, manipulate or mislead you during your audit.
29. Not used.
30. Not used.
31. SDCERS' receivables reported in the City's basic financial statements represent valid claims against debtors arising on or before the date of the statement of net assets and have been appropriately reduced to their estimated net realizable value.
32. SDCERS is responsible for determining the fair value of certain investments as required by GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. The amounts reported represent the SDCERS' best estimate of fair value of investments required to be reported under the Statement. SDCERS also has disclosed the methods and significant assumptions used to estimate the fair value of its investments, and the nature of investments reported at amortized cost.

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33. Not used.
34. SDCERS' expenses have been appropriately classified in or allocated to functions and programs in the statement of changes in fiduciary net assets, and allocations have been made on a reasonable basis.
35. SDCERS' revenues are appropriately classified in the statement of changes in fiduciary net assets.
36. SDCERS' interfund, internal and intra-entity activity and balances have been appropriately classified and reported.
37. SDCERS' special and extraordinary items are appropriately classified and reported.
38. Not used.
39. SDCERS has identified and made the appropriate disclosures for all derivative instruments not reported at fair value in the financial statements in accordance with GASB Technical Bulletin 03-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*.
40. We agree that the findings of specialists in evaluating the adequacy of the Required Supplementary Information – Schedules of Trend Information are reasonable. We have adequately considered the qualifications of the specialist in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give or cause any instructions to be given to specialists with respect to the values or amounts derived in an attempt to bias their work, and we are not otherwise aware of any matters that have had an impact on the independence or objectivity of the specialists.
41. We believe that the actuarial assumptions and methods used to measure pension liabilities and costs for financial accounting and disclosure purposes are appropriate in the circumstances.
42. In accordance with Government Auditing Standards, we have identified to you the significant findings and recommendations from previous financial audits, attestation engagements, performance audits, or other studies related to the objectives of this audit and have accurately communicated to you the related corrective actions taken to address the findings.
43. We confirm that all relevant information relating to the facts and circumstances affecting SDCERS, which are the subject of the Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure conducted by Kroll and Willkie Farr & Gallagher LLP have been disclosed by us to the Audit Committee, to the investigating team, and to you.

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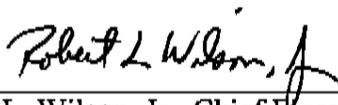
We also confirm that, where necessary, SDCERS has taken, or is taking, timely and appropriate remedial action. We are not subject to a Wells notice by the SEC and have no reason to believe that we are the subject of any investigation by the Department of Justice or the Securities and Exchange Commission.

44. We confirm that the information contained in Note 18, Contingencies, regarding the Securities and Exchange Commission (SEC) Order sanctioning the City is complete and accurate to our knowledge. Further, we are not aware of any noncompliance with the terms of that Order.
45. We acknowledge that KPMG must be independent in the performance of its audit. Accordingly, we represent that SDCERS has no present intention to commence litigation against KPMG.

Sincerely,



David B. Wescoe, Retirement Administrator
San Diego City Employees' Retirement System



Robert L. Wilson, Jr., Chief Financial Officer
San Diego City Employees' Retirement System



KPMG LLP
55 Second Street
San Francisco, CA 94105

**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.