PERFORMANCE AUDIT OF THE CITY'S FINANCIAL CONDITION

San Diego's Financial Condition
Remains Stable for
Fiscal Years 2015 and 2016

Office of the City Auditor

City of San Diego

OCA
Independent • Objective • Accurate

June 2018

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THE CITY OF SAN DIEGO

June 18, 2018

Honorable Mayor, City Council, and Audit Committee Members
City of San Diego, California

Transmitted herewith is an audit report on the City of San Diego's Financial Condition. This report was conducted in accordance with the City Auditor's Fiscal Year 2018 Audit Work Plan, and the report is presented in accordance with City Charter Section 39.2. The Results in Brief is presented on page 1. Audit Objectives, Scope, and Methodology are presented in Appendix A. Management's comments on our audit can be found after page 49.

We would like to thank the Chief Financial Officer, City Comptroller, and their staff for their assistance and cooperation during this audit. All their valuable time and efforts spent on providing us information are greatly appreciated. The audit staff responsible for this audit report are Rod Greek, Chris Kime, and Kyle Elser.

Respectfully submitted,

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City Auditor

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Table of Contents

Results in Brief

The City of San Diego's financial health is subject of continuous scrutiny by the public, news media, and policy makers. For most City residents, independently assessing the City's financial health is a daunting task requiring detailed analysis of the City's Comprehensive Annual Financial Reports and Fiscal Year Budgets. These documents can be technical, lengthy, and not particularly designed for public consumption. Financial analysis through the use of financial ratios can be used to draw meaning and thus give a voice to financial statements.

In an attempt to objectively assess and report the City of San Diego's financial condition, we used a well-regarded 10-point test presented by Dean Mead[1] in Public Financial Management (2006).[2] This test is comprised of ten financial ratios designed to assess performance in four areas: financial position, revenues, debt, and capital assets. The test includes both short-term and long-term aspects of financial well-being and relies on audited financial data published in cities' Comprehensive Annual Financial Reports. To give the ratios context, ratios are tracked for multiple years (FY 2007–FY 2016 in our test), and compared to other cities similar in population (Philadelphia, PA; Phoenix, AZ; San Antonio, TX; Dallas, TX; San Jose, CA; and Austin, TX in our test).

The City of San Diego's financial ratios overall indicate consistent positive financial health from FY 2012 through FY 2016. The City's financial condition has been among the best for the last 10 years when compared to six other cities with comparable populations. Overall, the City ranked either 1st or 2nd for each of the years tested.

The City's ratios for revenues and debt coverage were strong in FY 2016, and the other ratios all scored well when compared to the other six cities with the exception of Short-run Financial Position (ranked 4th), Liquidity (ranked 4th), and Net Change in Capital Assets Value where San Diego ranked 5th. Although the Short-run Financial Position ratio ranked 4th, it was 14% in FY 2016 and still well above the 8% minimum requirement set by the City.

While the ten-year trend from FY 2007 to 2016 is positive for all the City's financial ratios, we identified some short-term changes that management should consider monitoring more closely. These include:

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[1] Dean Mead is a Research Manager at the Governmental Accounting Standards Board (GASB).

[2] The modified 10-point test is fully explained in "A Manageable System of Economic Condition Analysis for Governments," which is Chapter 15 of the textbook *Public Financial Management* (CRC Press, 2006).

- Ratio 2 – Liquidity was consistently above the average for benchmark cities from FY 2009 through FY2015. However, liquidity dropped from close to 4.0 in FY14 and FY15 to 3.2 in FY16 (higher is better). The decline was due to a $40 million reduction in cash & investments combined with a $10 million increase in accrued wages;
- Ratio 4 – Solvency, while strong compared to benchmark cities, it has risen from 1.42 in FY 2014 to 1.88 in FY 2016 (lower is better). This increase is mainly due to the pension liability now being included in the financial statements. Other cities are experiencing an even larger impact due to this change in financial reporting;
- Ratio 10 – Net Change in Capital Assets Value is now trending in a positive direction over the ten-year review period, but it remains as the City's lowest ranking metric. One-time spikes due to the addition of large capital projects can be anticipated, but long-term under-performance in this metric can be an indication that the City is under investing in its infrastructure when compared with other cities.

The City of San Diego has experienced financial challenges in the past, and it is a credit to stakeholders that steps have been taken to remedy the problems identified in the last decade. The Chief Financial Officer for the City stated,

"The Mayor and Council have consistently adhered to strong financial policies and practices allowing the City to continue to build upon its firm financial standing. In addition to maintaining cash reserves to protect the City from economic downturns and unforeseen events, the City adopts a structurally balanced budget each year, maintains strong expenditure controls, conducts long-term financial planning and adheres to responsible and equitable debt practices."

This audit is an update of our previous report in FY 2016 as we continue to monitor the City's financial condition. Financial decisions can only be as sound as the information upon which they are based. Therefore, a government's financial condition must be continually monitored and regularly evaluated to help ensure the City's decisions are fully informed and financially responsible. Financial ratio analysis should raise questions that seek to explain the differences between cities and evaluate the reasons for change over time. The discussion of financial ratios can lead to meaningful answers for policy-makers and stakeholders.

Background

What Is Financial Condition?

Financial condition can be broadly defined as a local government's ability to finance its services on a continuing basis. More specifically, financial condition refers to a government's ability to:

- Maintain existing service levels;
- Withstand economic disruptions; and
- Meet the demands of growth, decline, and change.

A basic assessment of a local government's financial condition involves evaluating whether the local government can continue paying for what it is doing, whether there are reserves for financing emergencies, and whether there is enough financial flexibility to allow the government to adjust to change. If a government can meet these challenges, it is in sound financial condition. If not, it is probably experiencing or can anticipate financial problems.

Historical Context

The City of San Diego (City) has experienced significant financial challenges in the past and has taken steps to remedy the problems identified in the last decade. The financial disclosure crisis of the last decade and subsequent investigations culminated in the Kroll Report which identified failures in the City's internal control environment and made several recommendations for improvement.

According to City leaders, by 2009, improvements had been made in the quality of the City's financial disclosures and practices, including its financial statements, its internal controls, and its disclosure controls and procedures. The City also released re-stated audited financial statements for Fiscal Year (FY) 2003; implemented an enterprise resource planning system, SAP; adopted an annual five-year financial outlook as a prudent planning tool; strengthened the City's General Fund reserves; and fully funded the annual required contribution to the City's pension system. Other improvements included the creation of the disclosure practices working group; establishment of financial policies (budget, reserve, debt, and investments); adoption of a new form of government (Strong Mayor); and creation of new offices—the Office of the City Auditor, and the Office of the Independent Budget Analyst.

San Diego Base Economy

The City's financial condition depends in many ways on the economic environment. According to the City's Economic Development Strategy for 2017 through 2019, the City's economy is based on four industries:

1. Manufacturing and Innovation
2. International Trade and Logistics
3. Military Installations
4. Tourism

These are sectors that bring money and wealth into the region. Therefore, growth or disruptions in these industries may have a particular effect on the City's financial condition.

Budget

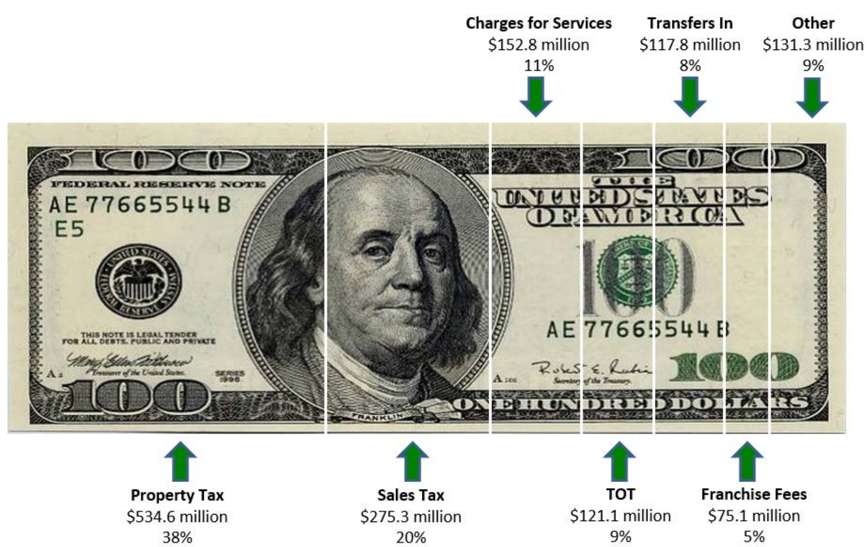
The City's FY 2018 Adopted Budget totals $3.6 billion and incorporates projections for an improved economic outlook based on the continuing trend of increases in median home prices, home sales, consumer spending, tourism, business travel, and employment levels. The Adopted Budget includes $1.4 billion for General Fund operations, $1.7 billion for operations of the City's Enterprise Funds and all other funds, and $476 million for capital improvement projects across the City.

General Fund Revenue Sources

In the City's FY 2018 Adopted Budget, the General Fund's largest outside revenue sources are property tax, sales tax, Transient Occupancy Tax (TOT), and franchise fees. The General Fund is supplemented by charges for services, transfers in, and other miscellaneous funds. **Exhibit 1** breaks down the revenue sources that finance the City's General Fund.

Exhibit 1

Fiscal Year 2018 Adopted Budget, General Fund Revenue



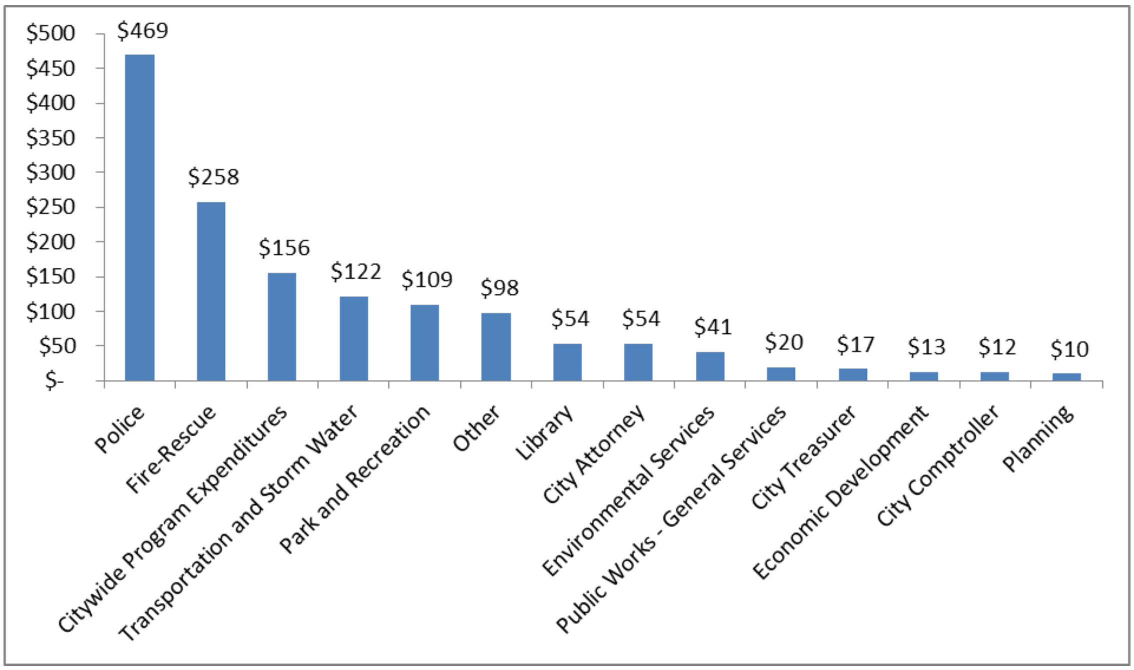
Source: City Auditor generated.

General Fund Expenditures

The City's FY 2018 Adopted Budget reflects General Fund expenditures totaling $1.43 billion and 7,527 budgeted full-time equivalent positions. Departments within the General Fund provide core community services, such as public safety (including police and fire protection), parks and recreation, library services, and refuse collection, as well as vital support functions such as finance, legal, and human resources. These core services are primarily supported by major revenue sources, as previously described. **Exhibit 2** summarizes the FY 2018 Adopted General Fund budgeted expenses by department, with those departments having a total General Fund expenditure budget of less than $10 million combined in the "Other" category.

Exhibit 2

FY 2018 Adopted Budget, General Fund Expenditures by Department (in Millions)



Note: The Other category includes: City Auditor, City Clerk, City Council, Communications, Debt Management, Department of Information Technology, Development Services, Ethics Commission, Financial Management, Human Resources, Infrastructure/Public Works, Internal Operations, Neighborhood Services, Office of Homeland Security, Office of the Assistant COO, Office of the Chief Financial Officer, Office of the Chief Operating Officer, Office of the IBA, Office of the Mayor, Performance & Analytics, Personnel, Public Utilities, Public Works - Contracting, Purchasing & Contracting, and Real Estate Assets.

Source: FY 2018 Adopted Budget.

Debt Obligations

The outstanding principal for the City's existing long-term debt obligations[3] as of June 30, 2017 are as follows:

- General Fund backed Lease-Revenue Bonds and Capital Lease Obligations: $736 million
- Public Utilities-Water System Obligations: $730 million
- Public Utilities-Wastewater (Sewer) System Obligations: $926 million

Departments Involved in Managing San Diego's Financial Condition

The City's financial condition is multi-faceted and depends on the work performed by several departments, which are overseen by the Chief Financial Officer (CFO):

- City Comptroller—financial reporting, disbursements, and internal controls
- City Treasurer—receivables, banking, and investments
- Debt Management—financing
- Financial Management—budgeting and fiscal consulting
- Risk Management—financial risk management, self-insurance programs

In addition to the departments overseen by the CFO, the Office of the Independent Budget Analyst assists the City Council with budgetary inquiries and budgetary decisions. For more about these departments and their responsibilities, refer to **Appendix B**.

New Accounting Standard Impacting Ratios

The Governmental Accounting Standards Board (GASB) Statement 68 – Accounting and Financial Reporting for Pensions effective for FY 2015 going forward. Implementation of this standard required governments to include the entire Net Pension Liability in the financial statements. The following ratios will be impacted by this new Standard:

- Financial Performance
- Solvency
- Primary Government Liabilities Per Capita

This standard also required governments to enhance the footnote disclosure related to Pensions. We have added a section in this report following the Mead Ratio Analytics to compare some of the metrics now reported in the footnotes.

[3] These do not reflect debt obligations of City Agencies (including the City as the Successor Agency to the Redevelopment Agency), Community Facilities Districts, or Special Assessment Districts.

Assessing Financial Condition

Several methods, with varying degrees of complexity and comprehensiveness, exist for assessing a local government's financial condition. We selected the modified 10-point test, as presented by Dean Mead in *Public Financial Management*, because it incorporates both short-term and long-term aspects of a city's financial well-being, while being relatively straightforward and easy to use.[4]

10-Point Test and Comparable Cities

The original 10-point test, introduced by Dr. Ken Brown in 1993, addressed four factors relevant to financial well-being—revenues, expenditures, operating position, and debt structure. However, Mead argues that it focuses nearly entirely on the short-term finances of governmental activities. According to Mead, any financial analysis should encompass both short- and long-run financial information. Furthermore, not only should the government as a whole be considered, but governmental activities should be considered separately from the business-type activities to distinguish financial results that may be masked when information is aggregated at the government-wide level. Finally, Mead suggests that to make the financial ratios of the 10-point test most meaningful, they need the context provided by a comparison to prior years and similar governments.

The 10-point test begins with the calculation of 10 ratios for the pulled from Comprehensive Annual Financial Reports (CAFRs)[5] for the 10 preceding years. Each ratio is then compared and scored with ratios computed for a peer group of similar governments (in terms of population, total revenues, geographic proximity, or other measure) from CAFRs during the same period of time. The total score can also be rated against the scores of comparable governments. The 10 ratios and their descriptions are shown in Exhibit 3.

[4] Appendix A of this report further explains the rationale for using this method.

[5] Appendix C provides more information on CAFRs and specific financial statements used in this audit.

Exhibit 3

10-Point Test Ratios and Descriptions

Category	Ratio	Ratio Description
Financial Position	1. Short-run Financial Position	Ability to handle unforeseen resource needs over the short-term.
	2. Liquidity	Ability to meet short-term obligations with current assets.
	3. Financial Performance	How well the City was able to pay expenses with revenues from that year.
	4. Solvency	City's overall capacity for repaying all of its obligations based on annual revenue.
Revenues	5. Primary Government [6] Revenues	Flexibility of City's revenues based upon reliance on intergovernmental aid, including grants.
	6. Governmental Activities[7] Revenues	Extent to which Governmental Activities are self-financed or dependent upon taxes.
Debt	7. Primary Government Debt Burden	Long-term debt burden upon City's residents. (Maturity greater than one year).
	8. Government Funds Debt Coverage	The principle and interest that the City must pay each year on debt as a percentage of operating costs.
	9. Enterprise Funds Debt Coverage	The sufficiency of resources available to repay business-type debt.
Capital Assets	10. Net Change in Capital Assets Value	Change in net value of assets for primary government. (Compares rate of investment in capital assets to depreciation of assets.)

Source: City Auditor generated.

In using the modified 10-point test to assess the City's financial condition, we selected six cities for comparison based on government type and population size. We selected the three US cities with populations immediately greater than San Diego (Phoenix, Philadelphia, and San Antonio), and the three US cities with populations immediately smaller than San Diego (Dallas, San Jose, and Austin) for inclusion in the comparison group.[8]

Investor Caveat

The Office of the City Auditor developed this report, and it is intended for the public. The report is the result of a performance audit and was not part of the annual audit of the City's financial statements. Expressions of opinion in the report are not intended to guide prospective investors in securities offered by the City.

[6] See Appendix C.1. for definition of Primary Government

[7] See Appendix C.1. for definition of Governmental Activities

[8] Refer to Appendix A of this report for more on the rationale for using population size as a basis of comparison.

Audit Results

San Diego's financial condition scored among the best compared to the benchmark cities, improving over the last 10 years as the scores have trended upward and stabilized at a healthy score of 16 for the last four fiscal years.

San Diego's individual ratio scores were calculated based upon awarding two points for each ratio that fell in the top quartile (top 25 percent) of the comparison group. One point was given for each in the second quartile, and no points for a ratio in the third quartile. A point was subtracted for a ratio in the lowest quartile. San Diego's ratio scores are summarized below in **Exhibit 4** by fiscal year.

Exhibit 4

San Diego Financial Condition Ratio Scores

Ratio	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016	Total
Short-Run Financial Position	1	1	1	1	1	1	1	1	1	1	**10**
Liquidity	-1	-1	0	0	1	2	1	1	1	1	**5**
Financial Performance	1	2	1	1	0	2	2	2	2	2	**15**
Solvency	1	1	1	1	1	2	2	2	2	2	**15**
Primary Government Revenues	2	2	1	2	2	2	2	2	2	2	**19**
Governmental Activities Revenues	1	1	1	0	0	1	2	2	2	2	**12**
Primary Government Debt Burden Per Capita	2	2	2	2	2	2	2	2	2	2	**20**
Governmental Funds Debt Coverage	1	2	2	2	1	2	2	2	2	2	**18**
Enterprise Funds Debt Coverage	2	2	2	2	2	2	1	1	1	2	**17**
Net Change in Capital Assets	0	-1	0	0	-1	-1	1	1	1	0	**0**
Annual Totals	10	11	11	11	9	15	16	16*	16	16	

Note: *Previous Liquidity score was 2. One point deducted for change in FY 2014 quartile score.

Source: City Auditor generated.

San Diego's highest scores for the 10-year period were related to debt and primary government revenues, while the lowest scores were in liquidity and capital assets, based on the scale of -10 being the lowest and 20 points being the highest. Solvency remains strong for the City, however the pension liability is now part of this metric resulting in increases to the solvency ratio.

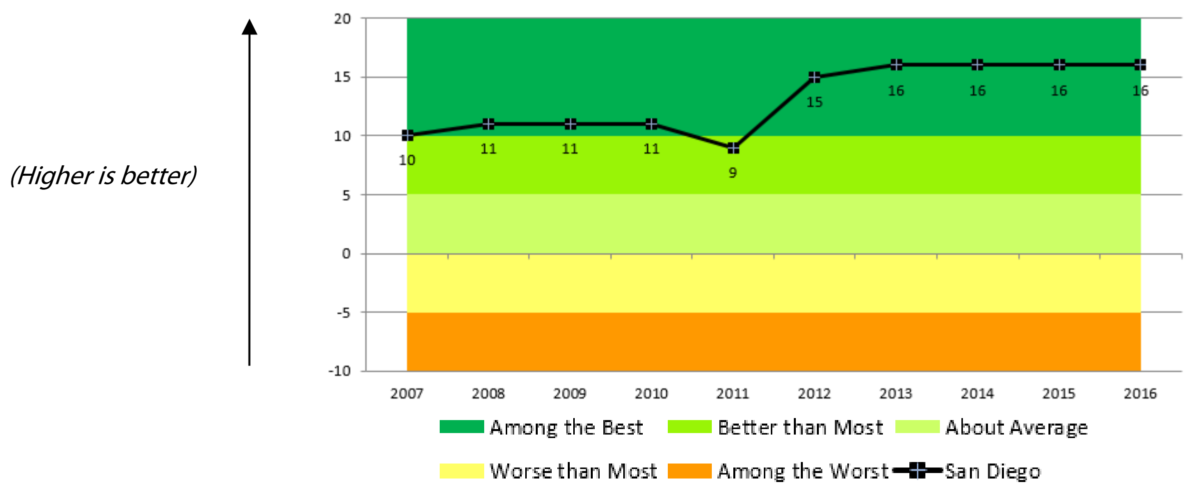
The City's liquidity ratio score improved the most going from -1 at the beginning of the ranking period and reaching 2 points in FY 2012 remaining at 1 point since FY 2012. Even though the City improved significantly, the ratios for San Diego's net change in capital assets have been above the benchmark cities' average in both FY 2015 and FY 2016. In FY 2015, there was a sharp spike in the change in capital assets for San Diego due to the addition of the $330 million San Vicente Dam project. This ratio remains the least favorable for San Diego.

San Diego's 10-Point Test Score

San Diego's financial condition scored among the best compared to the benchmark cities, improving over the last ten years as the scores trended upward as shown in **Exhibit 5**. In FY 2012, increases in the metrics for Liquidity, Financial Performance, Solvency, Gov't Activities Revenues, and Debt Coverage created the jump to the higher bar for the City of San Diego. The City has been stable at a level of 16 points from FY 2013 to FY 2016.

Exhibit 5

San Diego 10-Point Test Scores



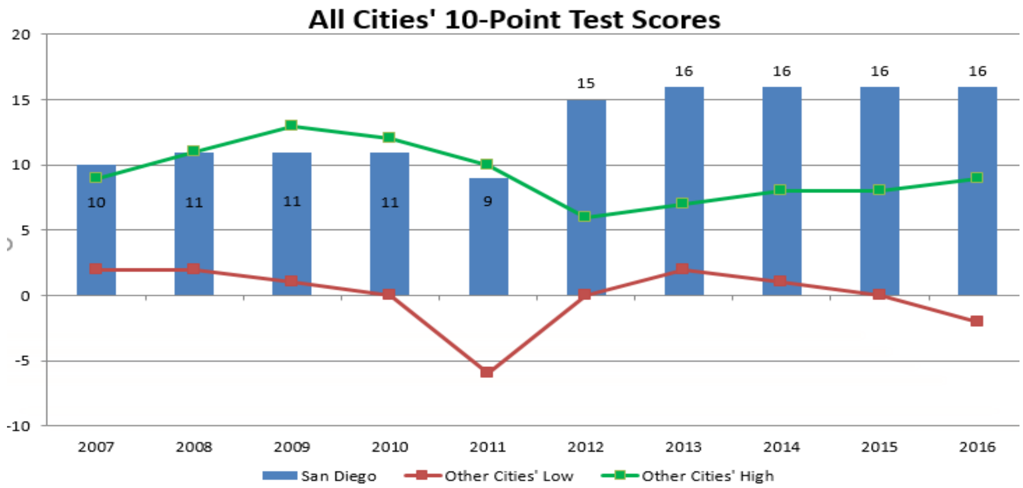
Source: City Auditor generated.

San Diego Score Compared to Benchmark Cities

San Diego's FY 2016 score of 16 exceeded the other cities' scores, which ranged between a high of 9 and low of -2. In fact, the highest score for any of the other cities during the 10-year period was 13. San Diego's score was at least double the other cities' highest score for FY 2012 through 2015. **Exhibit 6** shows San Diego's score in relation to the other tested cities' high and low scores.

Exhibit 6

San Diego's Score Comparison



Source: City Auditor generated.

San Diego Ranked to Benchmark Cities

San Diego was ranked either first or second for all the years during the test period. The City was tied for first in FY 2008 and tied for second in FY 2011 among the benchmark cities. **Exhibit 7** displays the City's annual rank.

Exhibit 7

San Diego's Annual Rank

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
1st										16
2nd										9
3rd										7
4th										6
5th										4
6th										0
7th										-2

Source: City Auditor generated.

Chief Financial Officer Remarks Related to the City's Scores

The City Auditor's performance audit highlights continued and sustained strength in the City's financial condition. The Mayor and Council have consistently adhered to strong financial policies and practices allowing the City to continue to build upon its firm financial standing. In addition to maintaining cash reserves to protect the City from economic downturns and unforeseen events, the City adopts a structurally balanced budget each year, maintains strong expenditure controls, conducts long-term financial planning and adheres to responsible and equitable debt practices.

Financial reforms that will continue to benefit the City's financial condition include the closing of the City's pension system to all new hires except police officers and the creation of a 401(k)-style defined contribution plan that brings greater predictability and reduced risk to the City. They also include reforms to retiree healthcare benefits which significantly reduced the City's retiree healthcare obligations. The City has consistently made its full pension payment for over ten years and has prefunded retiree healthcare obligations through a trust fund.

The City Auditor's performance audit focuses on activity and balances from Fiscal Year 2016 and prior. Recent developments further showcase the City's strong financial performance. In 2017, the City's credit rating was upgraded by Fitch Ratings. Fitch Ratings commented on the City's "exceptionally strong gap closing capacity and satisfactory reserves [that] result from the City's strong general fund revenue performance, solid expenditure flexibility, healthy economy and tax base, conservative financial management policies, and strong financial planning and disclosure practices." In May 2018, Standard & Poor's placed the City on a positive outlook.

Other recent developments include the increase in reserve policy levels for the General Fund, from 14% to 16.7% of General Fund revenues, and establishment of a new pension stabilization reserve to reduce the impact of significant increases to the City's annual pension payment. Reserves continue to be funded each year at increased levels in accordance with the City's reserve policy.

It is important to note that even when comparing cities of similar population, there may be significant differences between them, including different functions performed for their residents, differences in socioeconomic, political and regulatory environments in addition to opportunities and limitations afforded by their geographic location and natural environment. There are also differences relating to revenue or debt raising ability among local agencies in California compared to localities in other states.

The metrics included in this report are based on formulas that provide a high-level view of each city's financial condition. A more complete assessment can only be achieved through a careful review and understanding of each city's annual financial statements and note disclosures. There could be significant transactions, such as the construction of a large capital project or the receipt of a large legal settlement that could impact the result of some of the metrics in any given year.

Ratio 1: Short-Run Financial Position

Formula = Unreserved General Fund Balance ÷ General Fund Revenues

The short-run financial position ratio measures the City's ability to handle unforeseen resource needs over the short-term.

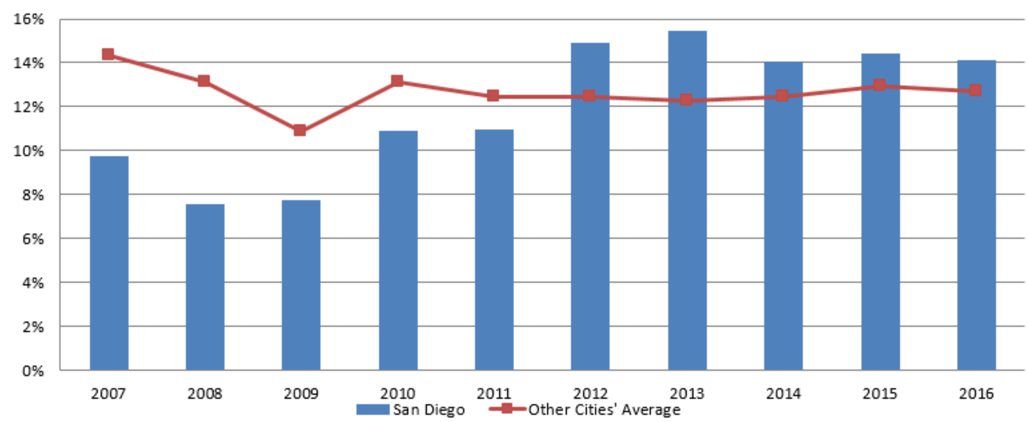
The City of San Diego had over $197 million in Unassigned (Unreserved) General Fund Balance and Emergency Reserves that equaled 14% of General Fund Revenues at the end of FY 2016. The City improved performance from a low of 7.6% in FY 2008 to a high of 15.5% in FY 2013. This means that the City's FY 2016 Unreserved General Fund balance would be sufficient to keep the City's basic functions running for approximately fifty-two days.

Exhibit 1:

Short-Run Financial Position

(Higher is better)

A high ratio suggests larger reserves for dealing with unexpected resource needs in the near-term.



Source: City Auditor generated.

During the first half of the 10-year period, San Diego's ability to meet short-term needs was below the bench mark cities' average. Conversely, San Diego's ratio improved during the last five years showing better-than-average ratios. This improvement was influenced by San Diego's FY 2011 revised reserve policy to have a minimum of 8% of annual General Fund revenues held in the General Fund Reserve by FY 2012. The City added a Pension Stabilization Reserve fund in FY2016 which is included in the above calculation.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
1st										20.1%
2nd										18.1%
3rd										16.9%
4th										14.1%
5th										13.7%
6th										7.5%
7th										0.0%

Source: City Auditor generated.

San Diego's ranking was fourth compared to the other cities for the entire 10- year period except when it improved to third in FY 2013.

Ratio 2: Liquidity

Formula = General Fund Cash and Investments ÷ (General Fund Liabilities – General Fund Deferred Revenues)

The liquidity ratio measures the City's ability to meet its short-term obligations with current assets. Although liquidity changes constantly, an annual year-end look is useful. Unless the government experiences major changes in receipt of revenues or disbursement of funds, the City should be at the same point in its cash flow cycle at the end of each year. A low ratio can be a warning that may indicate a cash flow problem and a need for short-term borrowing. Specifically, a ratio below one suggests an inability to pay current obligations.

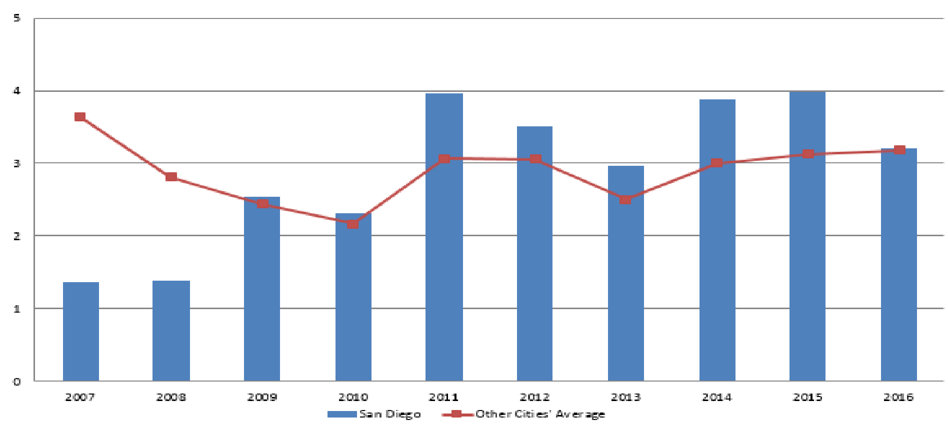
The City of San Diego's liquidity ratio has trended upward in the last ten years from a low of 1.4 in FY 2007 to a high of 4.0 in FY 2015. This means that the City had the capacity to pay current bills four times over in FY 2015.

Exhibit 1:

Liquidity

(Higher is better)

A high ratio suggests a greater capacity for paying off short-run obligations.



Source: City Auditor generated.

The City's liquidity ratio improved significantly during the 10-year period and was consistently above the average for benchmark cities from FY 2009 through FY2015. This suggests that San Diego's capacity to pay current bills is better than most of the benchmark cities. However, liquidity has dropped from to the 4.0 range in FY 2014 and FY 2015 to 3.2 in FY16 (higher is better). The decline was due to a $40 million decrease in cash and investments combined with a $10 million increase in accrued wages when compared to FY 2015.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
1st										5.5
2nd										3.9
3rd										3.4
4th										3.2
5th										3.1
6th										2.4
7th										0.8

Source: City Auditor generated.

At the beginning of the ten-year period, San Diego was ranked seventh, improving to second in FY 2012 and FY 2014, and is now fourth in FY 2016.

Ratio 3: Financial Performance

Formula = Change in Governmental Activities Net Assets ÷ Total Governmental Activities Net Assets

The financial performance ratio measures the rate at which a city's financial resources are growing or declining. Utilizing the change in net assets for governmental activities, this ratio demonstrates how well the City was able to pay expenses with revenues from that year. In other words, the ratio demonstrates the City's ability to make ends meet. A positive percentage demonstrates improved financial performance, which indicates the City is in a better position to face future financial challenges. This ratio is highly sensitive to economic factors outside the City's control, such as a decline in tourism as a result of a recession. Although a high ratio suggests the City is doing a better job of balancing revenues and expenses each year, a very high ratio could suggest that a city is raising too much revenue or under-spending on needed services.

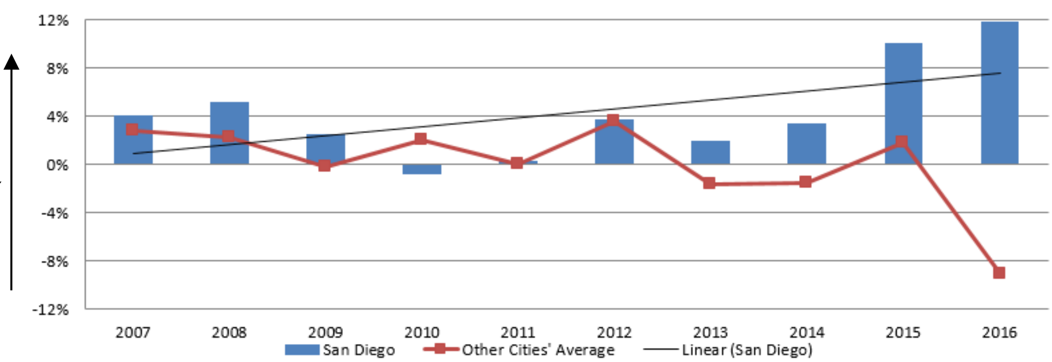
The City of San Diego's financial performance ratios during the ten-year period ranged from a high of 11.9% in FY 2016 to a low of -0.8% in FY 2010. The City's revenues exceeded expenses by $513,702,000 in FY 2016, which means net assets increased by 11.9%.

Exhibit 1:

Financial Performance

(Higher is better)

A high ratio suggests that annual costs are being adequately financed and financial positon is improving.



Source: City Auditor generated.

San Diego's ratio was 13 percentage points above the nearest benchmark city in FY 2016 and the City's financial performance has dramatically improved, with this financial ratio tripling over the FY 2014 level of 3.4%.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
1st										**11.9%**
2nd										-1.0%
3rd										-1.2%
4th										-2.0%
5th										-4.6%
6th										-22.1%
7th										-24.0%

Source: City Auditor generated.

San Diego was ranked 1st for the last two years and 2nd for four of the previous eight years. The only year San Diego was ranked below 3rd was in FY 2011 when it was ranked 5th among the benchmark cities.

Ratio 4: Solvency

Formula = (Primary Government Liabilities – Deferred Revenues) ÷ Primary Government Revenues

The solvency ratio adds a long-run dimension to the analysis of the City's operating position. It is an indicator of the City's overall capacity for repaying or otherwise satisfying all of its outstanding obligations based on annual revenue. A low ratio suggests that annual revenues are sufficient for satisfying the City's liabilities.

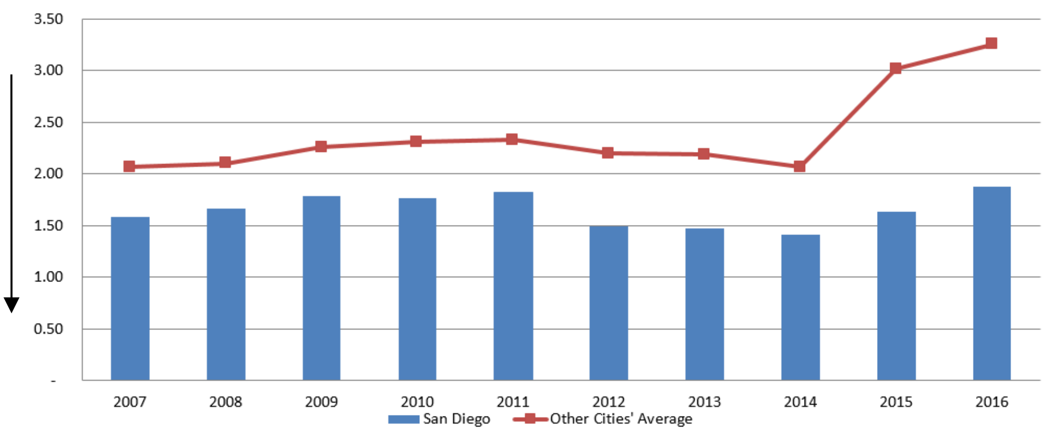
San Diego's solvency ratio, while strong compared to benchmark cities has risen from 1.42 in FY 2014 to 1.88 in FY16 (lower is better). This increase is mainly due to the pension liability now being included in the financial statements. Other cities are experiencing an even larger impact due to this change in financial reporting. In FY 2016, the City would have needed almost $2.7 billion of additional revenue to cover all of its outstanding obligations. This means that the City's liabilities were 88 percent greater than the sum of annual revenues. This includes all long-term liabilities including pension for FY 2015 and FY 2016.

Exhibit 1:

Solvency

Lower is better)

A low ratio suggests outstanding obligations can more easily be met with annual revenues.



Source: City Auditor generated.

San Diego's solvency results improved through FY 2014 and the ratios were consistently below benchmark cities, widening the gap post GASB 68 implementation in FY 2015.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
1st										**1.88**
2nd										2.08
3rd										2.40
4th										2.58
5th										3.01
6th										3.41
7th										6.04

Source: City Auditor generated.

San Diego has consistently ranked above average for the 10-year period compared to the benchmark cities, improving from 3rd during the first five years to 1st in the last two years. Solvency remains one of the stronger metrics when compared against the other cities; however, the ratio is increasing mainly due to the pension liability now being included in the financial statements. With the implementation of new pension accounting rules, other cities are experiencing an even larger impact due to the inclusion of Pension Liability to the Financial Statements. A higher ratio may be an indication that it is becoming more difficult for a city to satisfy outstanding obligation with annual revenue streams.

Ratio 5: Primary Government Revenues

Formula = (Primary Government Operating Grants and Contributions + Unrestricted Aid) ÷ Total Primary Government Revenues

The primary government revenues ratio measures the flexibility of the City's revenues. The ratio considers different sources of revenues of the primary government, including business-type activities. Intergovernmental aid is revenue generated from other government entities and includes grants. Reliance on intergovernmental aid can be risky during an economic downturn because federal and state agencies frequently withdraw or reduce payments to local governments as a cutback measure. That said, it is important for local governments to maximize the acquisition of State and Federal Grants as they directly benefit the local economy. Prudent planning should be incorporated to anticipate the impacts of economic downturns and the impact it will have on the availability of intergovernmental funding.

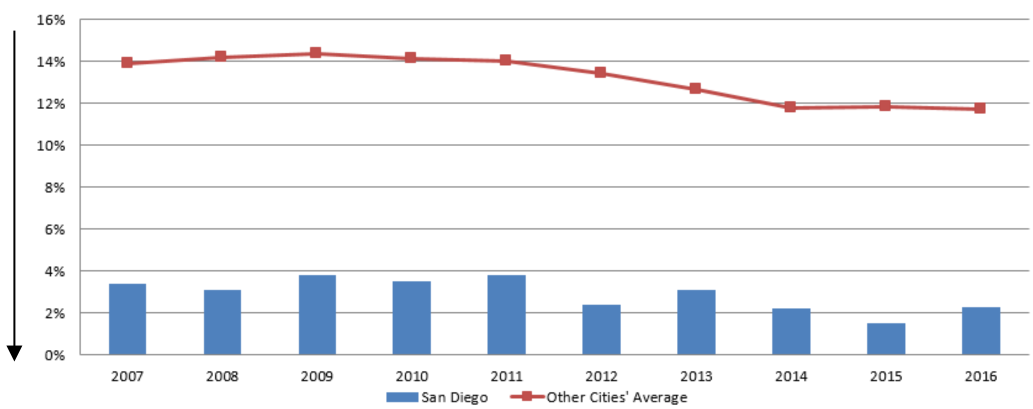
San Diego's primary government revenues ratio has improved by trending downward over the review period, from 3.4 percent in FY 2007 to 2.3 percent in FY 2016. At the end of FY 2016 the City relied only on about $68.8 million of intergovernmental aid or 2.3 percent of total revenues.

Exhibit 1:

Primary Government Revenues

(Lower is better)

A low ratio suggests a government is not heavily reliant on intergovernmental aid.



Source: City Auditor generated.

San Diego's 2.3 percent ratio in FY 2016 was 9.4 percentage points below comparison cities, showing that the City is not as heavily reliant on intergovernmental aid as other benchmark cities. San Diego's ratios consistently remained below the average of benchmark cities during the review period.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
1st										1.3%
2nd										**2.3%**
3rd										3.1%
4th										5.6%
5th										8.7%
6th										21.2%
7th										30.4%

Source: City Auditor generated.

While the ranking varied over the initial three years, the City maintained a 2nd place ranking for the last seven years, indicating a level of consistency when compared to benchmark cities.

Ratio 6: Governmental Activities Revenues

Formula = Net Revenue (Expense) for Governmental Activities ÷ Total Governmental Activities Expenses

The governmental activities revenues ratio measures the degree to which governmental activities are supported by taxes and other general revenues. This ratio shows the extent to which governmental activities' functions and programs are self-financed or the degree to which they depend on financing from governmental revenues, primarily taxes. A low ratio suggests services are less reliant on general revenue financing and are more self-supporting through charges for services, grants, and contributions.

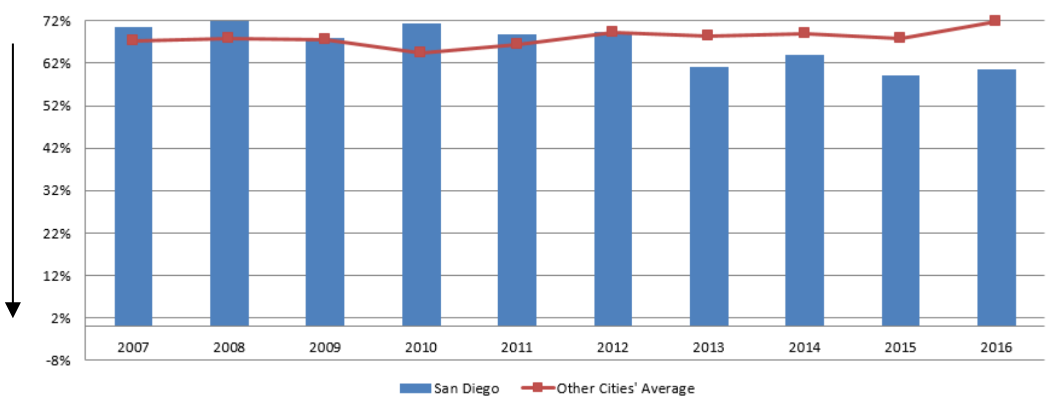
The City of San Diego has maintained relatively level taxpayer support for governmental activities, ranging between 59 percent and 72 percent during the 10-year review period. In FY 2016, Governmental Activities generated almost $669 million in charges, grants and contributions, which fell short of the expenses by almost $1.024 billion. This means 60 percent of $1.7 billion in expenses had to be funded through $1.024 billion in taxes and other general revenues. During FY 2015 and FY 2016, San Diego reduced reliance on general tax support to 59 percent and 60 percent respectively.

Exhibit 1:

Governmental Activities Revenues

(Lower is better)

A low ratio suggests basic government services are more self-sufficient and less reliant on general tax support.



Source: City Auditor generated.

Although San Diego's ratio increased at the beginning of the review period, the overall trend is positive with downward movement, meaning that the City's services are more self-reliant than in prior years.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
1st										**60.5%**
2nd										60.7%
3rd										61.2%
4th										73.0%
5th										75.4%
6th										76.6%
7th										84.3%

Source: City Auditor generated.

San Diego's ranking hovered around the middle of the benchmark cities during the first six years of the review period. In FY 2013 through FY 2015 San Diego was ranked 2nd, improving to 1st in FY 2016.

Ratio 7: Primary Government Debt per Capita

Formula = Total Outstanding Primary Government Long-Term Debt ÷ Population

The primary government debt burden per capita ratio identifies the level of long-term debt[9] burden on the City's residents. A low ratio suggests there is less debt burden imposed on taxpayers and a greater potential capacity for additional borrowing.

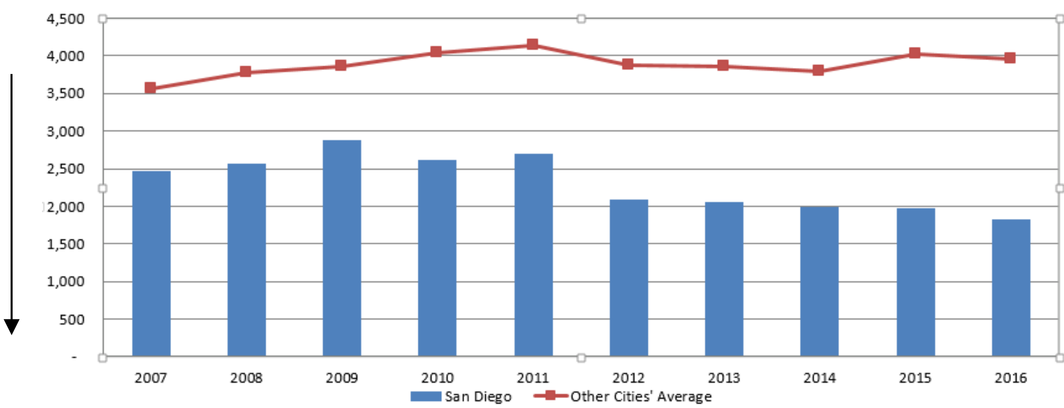
The City's per capita debt burden has trended downward, from $2,876 in FY 2009 to $1,829 in FY 2016. In FY 2016, the total outstanding long-term debt for the City of San Diego was almost $2.5 billion.

Exhibit 1:

Primary Government Debt per Capita

(Lower is better)

A low ratio suggests less burden on taxpayers and greater capacity for additional borrowing.



Source: City Auditor generated.

San Diego has maintained a level of long-term debt well below the average of benchmark cities. For example, the average debt for benchmark cities in FY 2016 was $3,965 debt per person, and the highest was $6,722. This suggests the City of San Diego is in a better position than benchmark cities to repay outstanding debt as well as for future borrowing.

[9] Long-term debt has a maturity of more than one year after issuance.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
1st										**$1,829**
2nd										$2,182
3rd										$2,520
4th										$3,722
5th										$4,197
6th										$4,445
7th										$6,722

Source: City Auditor generated.

San Diego consistently ranked 2nd among the benchmark cities for debt burden per capita until FY 2014. San Diego's debt per capita has dropped by $224 since FY 2013, remaining in the 1st ranking position since FY 2014.

Primary Government Liabilities per Capita

Formula = Total Primary Government Long-Term Liabilities ÷ Population

In addition to the primary government debt ratio, we calculated a ratio of all long-term liabilities, which was not part of the 10-point test. We calculated this ratio in order to assess whether the City's long-term liabilities were significantly different from its long-term debt. In addition to long-term debt, long-term liabilities included arbitrage liability, compensated absences, liability claims, estimated landfill closure and post closure care, net other postemployment benefits obligation, and net pension obligation.

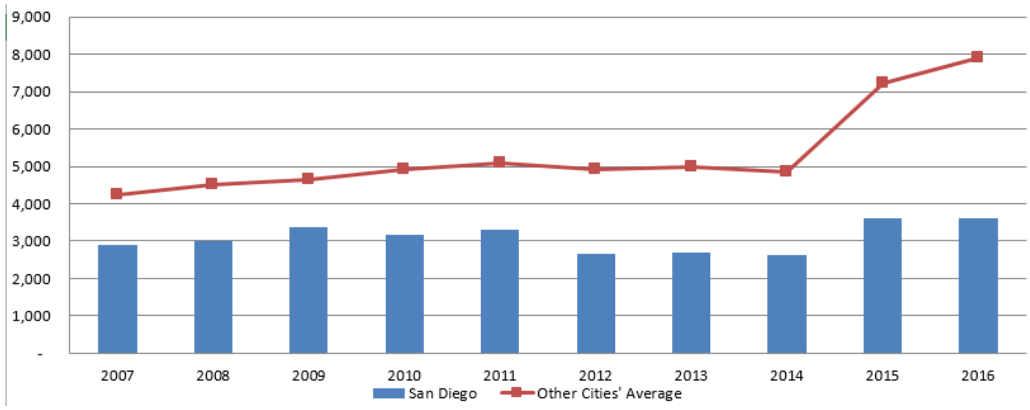
In FY 2016, the total long-term liabilities for the City of San Diego were over $5.0 billion. The long-term liabilities per capita were $3,627, which was $1,798 greater than the debt per capita of $1,829. The City's per capita liability burden has increased due to the implementation of GASB 68, Accounting and Financial Reporting for Pensions, which required the inclusion of Net Pension Liability in the financial statements beginning in FY 2015.

Exhibit 1:

Primary Government Liabilities per Capita

(Lower is better)

A low ratio suggests suggests less future burden on taxpayers.



Source: City Auditor generated.

San Diego has maintained a level of long-term liabilities well below the average of benchmark cities. After GASB 68 implementation, benchmark cities had over twice the long-term liabilities per capita as San Diego.

Ratio 8: Government Funds Debt Coverage

Formula = Debt Service Expenditures ÷ Noncapital Governmental Funds Expenditures

The government funds debt coverage ratio measures debt service expenditures in relation to operating costs. These expenditures are the annual amount of principal and interest on long-term debt and the amount of interest on short-term debt that a city must pay each year. Debt service expenditures reduce spending flexibility by adding to a city's obligations and can be a major component of fixed costs.

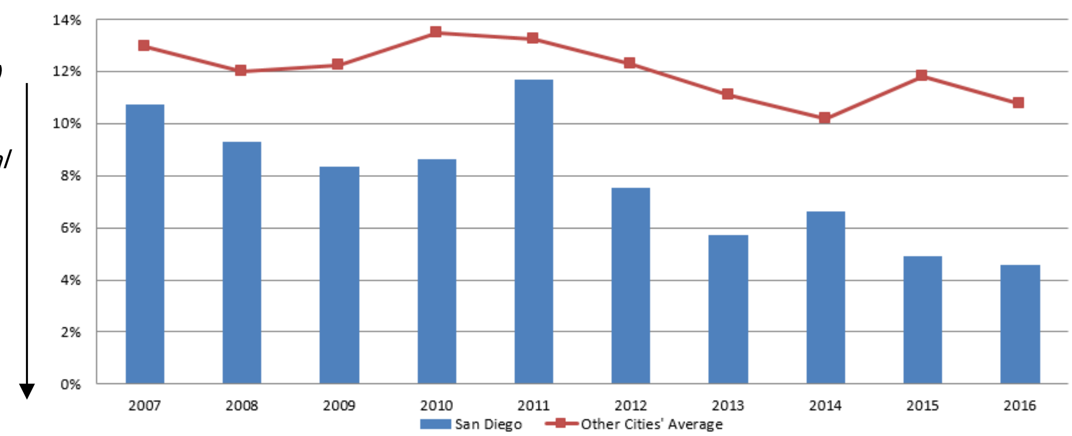
During FY 2016, San Diego's debt service expenditures amounted to $78 million or 4.6% of operating expenditures. During the ten-year review period, San Diego's government funds debt coverage ratio ranged from a high of 11.7% in FY 2011 to a low of 4.6% in FY 2016 and was always below the average of benchmark cities. Despite fluctuations, the ratio shows an overall positive trend.

Exhibit 1:

Government Funds Debt Coverage

(Lower is better)

A low ratio suggests general governmental long-term debt can be more easily repaid.



Source: City Auditor generated.

San Diego's FY 2016 ratio was 6 percentage points below the average of benchmarked cities and 12 percentage points below the highest benchmark ratio. During the last ten years, San Diego's governmental funds debt coverage ratio was below the average of other cities, indicating greater flexibility for future spending.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
1st										3.9%
2nd										**4.6%**
3rd										8.3%
4th										9.5%
5th										10.6%
6th										15.3%
7th										16.8%

Source: City Auditor generated

The City consistently remained in the top 3 rankings when compared to the other cities during the entire 10-year period, ranking 1rst in FY 2015.

Ratio 9: Enterprise Funds Debt Coverage

Formula = (Enterprise Operating Revenue + Interest Expense) ÷ Interest Expense

The enterprise funds debt coverage ratio indicates the sufficiency of resources available to repay business-type debt. The City uses enterprise funds to account for its Sewer Utility, Water Utility, Airports, Development Services, Environmental Services, Golf Courses, and Recycling. These business-type activities are generally financed, at least in part, through fees and charges.

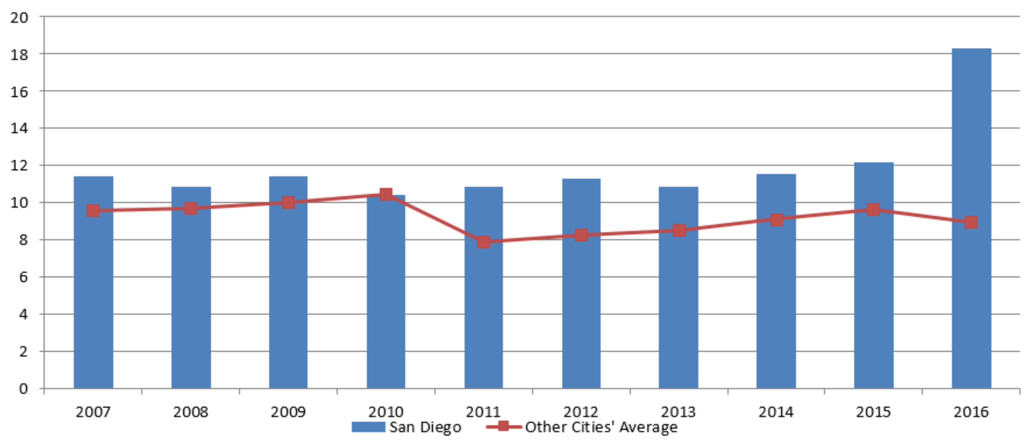
The City of San Diego had a sizable increase from 12.0 in FY 2015 to18.3 in FY 2016. San Diego paid $52 million interest expense during FY 2016, $19.2 million less than in FY 2007.

Exhibit 1:

Enterprise Funds Debt Coverage

(Higher is better)

A high ratio suggests greater resource availability for repaying the debts of enterprise activities as they come due.



Source: City Auditor generated.

San Diego's ratio has been relatively favorable compared to the average of benchmark cities. This suggests that San Diego is in a better position to repay enterprise fund debt than benchmark cities.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
1st										**18.3**
2nd										12.9
3rd										9.5
4th										8.6
5th										8.4
6th										7.5
7th										6.6

Source: City Auditor generated.

San Diego jumped to the top ranking in FY 2016, 5.4 points above the 2nd ranked city.

Ratio 10: Net Change in Capital Assets' Value

Formula = (Ending Net Value of Primary Government Capital Assets – Beginning Net Value) ÷ Beginning Net Value

This ratio measures the change in net value of capital assets. A high ratio suggests a government is keeping pace, on average, with the aging of its capital assets and replenishing them. A positive percentage change suggests the capital assets are being replenished; a negative number suggests they are being depleted.

One-time spikes due to the addition of large capital projects can be anticipated, but long-term under-performance in this metric can be an indication that the city is under-investing in its infrastructure when compared with other cities. This ratio is not intended to evaluate the capital assets' condition---it is the replenishment of overall assets.

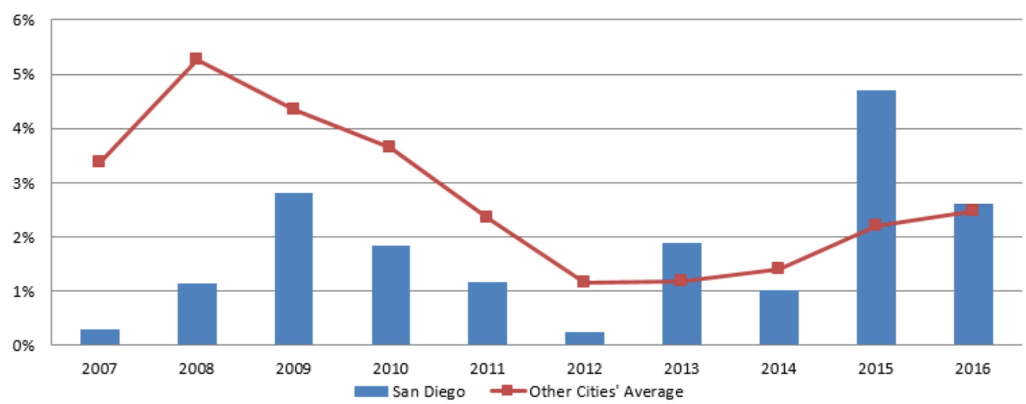
The City's ratio is now trending in a positive direction over the ten-year review period. In FY 2015 the City of San Diego booked the completion of the San Vicente Dam raise which created a spike in this calculation. Even without this addition, the City of San Diego would have achieved a percentage between 1% and 2% for FY 2015 resulting in a positive trend since FY 2012.

Exhibit 1:

Net Change in Capital Assets' Value

(Higher is better)

A high ratio suggests a government is keeping pace, on average, with the aging of its capital assets and replenishing them.



Source: City Auditor generated.

Source: City Auditor generated.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
1st										5.6%
2nd										5.2%
3rd										3.4%
4th										2.8%
5th										**2.6%**
6th										-0.3%
7th										-1.8%

Source: City Auditor generated.

The City of San Diego ranked as high as 3rd among the benchmark cities in FY 2015, but was average or below average for the majority of the review period. The City was ranked 6th in three of those years, making this ratio the least favorable for San Diego's ten-point test

Pension Liabilities

Pension liabilities are not covered as a unique metric in the Mead 10-Point test, but have been an area of increasing concern by governing bodies and the public at large. To address these concerns, the Governmental Accounting Standards Board (GASB) has issued new disclosure standards[10] related to both Defined Benefit Pension Plans and Other Post-Employment Benefits (OPEB).

We will highlight some of the more important metrics regarding Pension Disclosure in this report. The following chart highlights the City of San Diego's position relative to the benchmark cities' statistics. Descriptions of each column follow the chart.

FY 2016 - General Pension Plan Comparison (see Note)

City	Funded Percentage	Investment Rate of Return	Inflation Rate	Net Pension Liability (NPL) (Thousands)	Contribution Rate as a % of Payroll	NPL per $1.00 of Pay
San Diego	**78.8%**	**7.25%**	**3.3%**	**$ 1,713,566**	**42.8%**	**$ 2.84**
San Antonio	73.0%	6.75%	2.5%	$ 467,583	10.6%	$ 1.40
Austin	63.2%	7.50%	2.8%	$ 1,246,992	18.1%	$ 2.28
Dallas	60.0%	8.00%	3.0%	$ 2,165,359	14.0%	$ 5.51
Phoenix	54.0%	7.50%	3.5%	$ 1,832,716	25.3%	$ 3.87
San Jose	50.4%	7.00%	2.5%	$ 1,833,268	48.4%	$ 7.11
Philadelphia	40.1%	7.80%	3.3%	$ 6,519,235	39.4%	$ 3.89

Note: Only San Diego's and Philadelphia's pension includes safety services. The other Cities have separate plans for safety services which would affect comparability to the more inclusive plans.

Source: FY 2016 CAFR for all cities.

[10] Standards governing Pension Plan disclosures are covered under GASB 67 and 68. Standard 67 covers disclosure requirements for the pension fund entities (Plan) with fiduciary responsibility for managing the investment portfolios, while GASB 68 covers disclosure requirements for government entities (Employer) with pension plans. GASB 67 became effective for plan fiscal years beginning after June 15, 2013, with GASB 68 becoming effective for employers one year later for fiscal years beginning after June 15, 2014.

For OPEB, the GASB Standards are 74 and 75. The effective dates for these Standards are:

- Plans – Effective for fiscal years beginning after June 15, 2016
- Employers - Effective for fiscal years beginning after June 15, 2017

Since this review period covers FY 2015 and 2016, the Pension GASB's were effective, but the OPEB standards will not be effective until our next reporting period.

Pension accounting is complex. Assumptions are used by actuaries to estimate the City's Net Pension Liability. More conservative assumptions can have a significant impact on these calculations. As such, the data in the above chart should not be used in isolation, but rather in combination to understand the health of the Pension Plan.

- **Funded Percentage (Plan Fiduciary Net Position as a Percentage of the Total Pension Liability):**
  - Higher percentage indicate a healthier plan. (higher is better)
    - The City of San Diego has the highest Funded Percentage. This is a percentage of available plan assets to the total pension liability and is impacted by actuarial assumptions.
- **Investment Rate of Return (IRR):**
  - Commonly referred to as the Discount Rate. A lower percentage is considered more conservative as the investment pool is more likely to meet the set benchmark (lower percentage is better). SDCERS has been systematically decreasing this metric since the high of 8% prior to the 2008 valuation.
    - The City of San Diego has the third lowest IRR. To highlight the impact of this assumption:
      - If this assumption was 1% lower, the Net Pension Liability would be $2.61 billion,
      - If it was 1% higher, it would be $966 million.
- **Inflation Rate:**
  - A higher percentage is considered more conservative. Inflation impacts projected future pension costs of the plan. (higher is better)
    - The City of San Diego has the second highest Inflation Rate assumption.
- **Net Pension Liability:**
  - This represents the unfunded pension liability. (lower is better)
    - Similar to Funded percentage, this is a product of the actuarial assumptions.
- **Contribution Rate as a % of Payroll:**
  - Higher percentage indicates the pension burden is greater per dollar of payroll (lower is better)
    - The City of San Diego has the second highest Contribution Rate. This higher contribution rate along with actual investment returns helps maintain the funded percentage of the plan.
- **NPL Per Dollar of Pay:**
  - Relation of unfunded pension liability to payroll. (lower is better)
    - The City of San Diego has the third lowest NPL per dollar of pay.

Note: SDCERS' Board exercises its fiduciary responsibility in the administration of the pension plan. This includes reviewing economic assumptions (investment rate, inflation rate, and COLA assumption) annually and demographic assumptions (mortality, rates of retirement, rates of disability, etc.) every five years. Changes to the assumptions may increase or decrease Pension Liabilities and as a result may change the Plan Fiduciary Net Position as a Percentage of the Total Pension Liability

Contingent Liabilities

During the previous audit presentation to the Audit Committee, there was discussion regarding Contingent Liabilities[11]. The Audit Committee was concerned there may be significant exposure to the City and requested information be provided in the next report. There is no prescribed test to compare these liabilities between agencies and as a whole are not part of the 10-point Mead test.

A contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to a government that will ultimately be resolved when one or more future events occur or fail to occur. Portions of Contingent Liabilities may be accrued, and if so, are included in the 10-point test for Liquidity and Solvency.

The City of San Diego reported the following Contingent Liabilities in the FY 2016 Financial Statements Note 17:

- Federal & State Grants are included because the granting agencies generally have requirements which must be adhered to. These agencies could request reimbursement for failure to comply
    - No Estimate (Note disclosure only)
- Litigation & Regulatory disclosure requires number of claims be reported and estimates/accruals be made if determinable:
    - 1,647 Claims
        - Estimates:
            - Not accrued - $0 - $234,466,000 (Note disclosure only)
            - Accrued - $198,362,000
- Pt Loma WWTP Modified Permit - Pure Water Program Facilities - Estimate (became a Commitment in FY 2017) – As a condition of receiving the permit to avoid upgrading to secondary treatment at Pt. Loma, the City must go forward with the Pure Water Project. As of June 30, 2016, the agreement was not finalized[12]. Estimated costs were:

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[11] According to the Governmental Accounting Standards Board (GASB), there are generally three types of note disclosures in the CAFR:

- Those that describe the accounting methods, policies, and choices underlying the amounts in the financial statements.
- Those that provide additional detail about or explanations of the amounts in the financial statements.
- Those that do not meet all the criteria to be recognized in the financial statements (for instance, because the amounts cannot be measured with sufficient reliability).

Most contingent liabilities fall into this third category of GASB required note disclosures. GASB standards make clear that the lists of specific disclosures are "neither all-inclusive nor intended to replace professional judgment" regarding what is necessary to achieve fair presentation. In other words, if a government believes that not disclosing a piece of information would cause the financial statements to be misleading, then it should disclose that information, even if it is not specifically required in the standards. Standards for reporting most contingent liabilities are contained in GASB 62 paragraphs 96 – 113. Pollution Remediation contingent liabilities are covered under GASB 49.

[12] Agreement was finalized in FY2017.

- Sewer Utility - $1,800,000,000 (Note disclosure only)
  - Ph 1 - Sewer Utility; $266,000,000 - $400,000,000
- Water Utility - $1,200,000,000 (Note disclosure only)
  - Ph 1 - Water Utility; $734,000,000 - $800,000,000

- Storm Water Pollution Remediation – The City is named as a responsible party in the cleanup and/or remediation of the three listed areas below:
  - No Reasonable Estimate - (Note disclosure only)
    - Los Penasquitos Lagoon Sedimentation Total Maximum Daily Load
    - Chollas Creek Mouth Sediment Investigative Order
    - Boat Channel at Naval Training Center

In addition to the Contingent Liabilities, the City of San Diego also discloses Contractual and Regulatory Commitments in Note 16 of the Financial Statements. Contractual commitments are legally binding obligations. Regulatory commitments are not encumbered, but estimates of future costs are disclosed in the footnote. In FY 2016 Commitments included the following:

- Contractual (Operating & Capital) – Encumbered: $398,926,000
  - General Fund - $10,055,000;
  - Non-Governmental Funds - $154,373,000;
  - Enterprise Funds - $234,498,000

- Regulatory (separate and distinct from Storm Water Pollution Remediation included in Contingent Liability Note)
  - RWQCB - Municipal Storm Water Permit; Water Quality Improvement Plans (WQIP's) - Estimate
    - FY 2017 – FY 2021: $771,855,000
    - FY 2022 – FY 2035: $2,527,781,000
      - Potential for cost reductions of $861 million between 2019 & 2028 are assumed in the costs identified above.
  - CA Dept. of Public Health Compliance Order – Estimate (unidentified portions may be encumbered as part of on-going CIP execution by Public Utilities)
    - FY 2017 – FY 2018:
      - Water System Capital Improvements: $51,960,000
      - 20 Miles of Water Main Replacement $30 – $40 Million

Conclusion

The City of San Diego's overall financial condition—in the areas of financial position, revenues, and debt—has stabilized over the last ten years, and is strong when compared to other cities of similar population size. While our financial analysis is limited to the 10-point test, our results suggest that the City is in a better position to finance its services on a continuing basis and poised to meet the demands of growth, decline, and change. These results are testament to the efforts made by City leaders over the last ten years, including the implementation of strong fiscal policies, practices, and controls.

City leaders and employees at all levels will need to continue stewardship of the City's finances. Adhering to conservative fiscal policies and practices will be an important element of this effort, as will monitoring the City's financial condition going forward. Continually monitoring the City's financial condition will raise important questions that policymakers and stakeholders must consider in the decision-making process. Evaluating long-term trends in relation to short-term changes will help flag areas in which management may want to provide greater focus. In this manner, continuous financial analysis will help ensure the City's decisions are fully informed and financially responsible.

Appendix A: Objectives, Scope, and Methodology

Objectives

In accordance with the Office of the City Auditor's FY 2018 Audit Work Plan, we conducted a performance audit of the City of San Diego's financial condition. Specifically, our audit objective was to examine the City's financial well-being in four areas—financial position, revenues, debt, and capital assets—by calculating 10 ratios, analyzing trends in the City's financial data over a 10-year period, and comparing the results to other cities of similar size.

Scope and Methodology

To address our audit objective, we selected the modified 10-point test for assessing financial condition for local governments, as presented by Dean M. Mead, Research Manager at the Governmental Accounting Standards Board (GASB). This method incorporates both short-term and long-term aspects of a city's financial well-being while being relatively simple, straightforward, and easy to use. This is because the method relies primarily on audited and reliable financial data published in the city's Comprehensive Annual Financial Reports (CAFRs).[13] This method also incorporates financial reporting changes made as a result of GASB Statement 34, which required governments to publish full accrual, government-wide information. This change made longer-run and more complete information available, which allows for the assessment of a more comprehensive concept of financial health.

[13] CAFRs used for San Diego and the comparison cities were obtained from their respective websites.

The modified 10-point test is based on 10 financial ratios, which are used as indicators for several aspects of the City's financial health. The ratios and the primary sources for the figures used to calculate them are listed in the following table.

Ratio#	Ratio Description	CAFR Source(s)
1	Short-run Financial Position: Unreserved General Fund Balance ÷ General Fund Revenues	Governmental Funds Balance Sheet; Governmental Funds Statement of Revenues, Expenditures, and Changes in Fund Balances
2	Liquidity: General Fund Cash and Investments ÷ (General Fund Liabilities – General Fund Deferred Revenues)	Governmental Funds Balance Sheet
3	Financial Performance: Change in Governmental Activities Net Assets ÷ Total Governmental Activities Net Assets	Government-Wide Statement of Activities
4	Solvency: (Primary Government Liabilities – Deferred Revenues) ÷ Primary Government Revenues	Government-Wide Statement of Net Assets and Statement of Activities
5	Primary Government Revenues: (Primary Government Operating Grants and Contributions + Unrestricted Aid) ÷ Total Primary Government Revenues	Government-Wide Statement of Activities
6	Governmental Activities Revenues: [Net (Expense) Revenue for Governmental Activities ÷ Total Governmental Activities Expenses] × –1	Government-Wide Statement of Activities
7	Primary Government Debt Burden: Total Outstanding Debt for the Primary Government ÷ Population	Long-Term Liabilities Note Disclosure and Statistical Section
8	Government Funds Debt Coverage: Debt Service ÷ Noncapital Governmental Funds Expenditures	Governmental Funds Balance Sheet or Statistical Section
9	Enterprise Funds Debt Coverage: (Enterprise Funds Operating Revenue + Interest Expense) ÷ Interest Expense	Proprietary Funds Statement of Revenues, Expenses, and Changes in Fund Net Assets
10	Capital Assets: (Ending Net Value of Primary Government Capital Assets – Beginning Net Value) ÷ Beginning Net Value	Capital Assets Note Disclosure

Source: Mead 10-Point Test.

To make the financial ratios of the 10-point test most meaningful, Mead suggested that the ratios needed the context provided by a comparison with prior years and with other, similar governments. Therefore, we calculated the 10 financial ratios for the City of San Diego over a period of 10 fiscal years (2007 through 2016), and calculated the same ratios for six other cities over the same period of time.

To select the benchmark cities, Mead suggested three characteristics as a basis for comparison:

1. Government type
2. Geographic region
3. Size (in terms of either financial activity, population, or both).

We selected benchmark cities based on government type and size. Since San Diego is the eighth largest city in the United States, selecting only benchmark cities in the same geographic region, or even within the state of California, would have made the comparison and resulting analysis less meaningful. For example, cities with a similar population size[14] tend to face similar challenges and service demands, which have a direct bearing on financial condition. We therefore prioritized population size as a characteristic of comparison over geographic region and selected benchmark cities with a population size within 500,000 of San Diego's. The following table lists the cities in the comparison group along with their estimated population size as of July 1, 2016.

City Name	Population Estimate (2016)
Phoenix	1,615,017
Philadelphia	1,567,872
San Antonio	1,492,510
San Diego	**1,406,630**
Dallas	1,317,929
San Jose	1,025,350
Austin	947,890

Source: US Census Bureau, Population Division.

After calculating the 10 financial ratios for San Diego and the benchmark cities from CAFR data, we compared San Diego's results to the benchmark cities' average and plotted these on a graph. We also ranked results for all cities in each of the 10 ratios and across all 10 years. We developed our conclusions based on this comparative analysis. Finally, we calculated quartile ranges for each individual ratio based on all of the cities' ratio values. We then assigned scores to each city based on its results in

[14] The only city in California with similar population size was San Jose, which was included in the comparison group. The next closest cities related to San Diego's population were Los Angeles with 3,976,322 and San Francisco with 870,887.

comparison to the other cities. We did this for each city in every ratio across all 10 years. In accordance with the modified 10-point test, we awarded two points for each ratio that fell in the top quartile (top 25 percent) of the comparison group. One point was given for each in the second quartile, and no points for a ratio in the third quartile. A point was subtracted for a ratio in the lowest quartile. We used the points and the resulting cumulative score to rate San Diego's financial condition relative to the benchmark cities. This relative rating is based upon the following scoring table:

Overall Score	Rating Relative to Other Cities
10 to 20	Among the Best
5 to 9	Better than Most
0 to 4	About Average
-5 to -1	Worse than Most
-10 to -6	Among the Worst

Source: Mead 10-Point Test.

Disclaimers Analyzing financial ratios provides a broad assessment of San Diego's financial condition, but it is important to recognize strengths and limitations to this sort of analysis. The table below highlights some of the strengths and limitations of our method.

Strengths	Limitations
Comparative data compiled under consistent accounting principles and audited under Government Auditing Standards.	Analysis provides a broad overview rather than detailed analysis.
Ratios developed independent of management and provides an independent view of the City's finances.	Excludes information on level and quality of services and infrastructure as well as external factors, such as demographic and economic trends, that may affect City finances.
The City's results are contextualized by comparison to cities of similar size.	Provides historical analysis rather than projections of future condition.
The City's results are contextualized by comparison over a 10-year period.	Results are a relative comparison, but do not provide the optimal ratio value a city should strive for.

Source: City Auditor generated.

All underlying financial information in this audit originates from the City's CAFRs. Accordingly, we relied on the audit work performed by the City's external financial auditors. We therefore did not audit the accuracy of source documents or the reliability of the data in computer-based systems. However, we did review information for reasonableness and consistency and questioned or researched data that was not reasonable or needed additional explanation.

Our review of data was not intended to give absolute assurance that all information was free from error. Rather, our intent was to provide reasonable assurance that the reported information presented a fair picture of the City's financial health. In addition, while this report offers financial highlights, it does not thoroughly determine the reasons for negative or positive performance. More in-depth analysis would be needed to provide such explanations.

This report was independently developed by the Office of the City Auditor and is intended for the general public as a high-level report. This report is the result of a performance audit, and was not part of the annual audit of the City's financial statements. Expressions of opinion in the report are not intended to guide prospective investors in securities offered by the City, and no decision to invest in such securities should be made without referencing the City's audited CAFRs and official disclosure documents relating to a specific security.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix B: City Departments Involved in Managing Financial Condition

How Does the City Manage Its Financial Condition?

The City's financial condition is multi-faceted and depends on the work performed by the departments shown below most which are overseen by the Chief Financial Officer (CFO):

City Comptroller:

- **Financial Reporting**
- **Disbursements**
- **Internal Controls**

The Office of the City Comptroller (City Comptroller) is responsible for the preparation of the Comprehensive Annual Financial Report (CAFR), which includes an accounting of all City funds and its component units. The CAFR also contains note disclosures that provide additional financial information and are necessary to fully understand the City's financial position. The City Comptroller performs the general accounting and financial reporting function for the City. The City Comptroller is also responsible for payment services, including payroll processing and centralized processing for all vendor payments. More recently, the City Comptroller added the Internal Controls Section, which is mainly responsible for implementing and monitoring internal controls over financial reporting and operations.

City Treasurer:

- **Receivables**
- **Banking**
- **Investments**

The Office of the City Treasurer is responsible for the receipt and custody of all City revenue, banking, tax administration, parking administration, parking meter operations, collection of delinquent accounts, and accounting for these funds. The City Treasurer is also responsible for the investment of all operating and capital improvement funds, including the reinvestment of debt proceeds of the City and its affiliated agencies.

Debt Management:

- **Financing**

The Debt Management Department conducts planning, structuring, and issuance activities for all City financings to fund cash flow needs and to provide funds for capital projects, essential equipment, and vehicles. The Department monitors outstanding bond issuances for refunding opportunities and performs, coordinates, and monitors certain post-issuance administrative functions.

Financial Management:
- **Budgeting**
- **Fiscal Consulting**

The Financial Management Department provides fiscal services to the Mayor and serves as an internal fiscal consultant to other City departments. Financial Management prepares the proposed and annual budgets in accordance with the City Charter. During the fiscal year, Financial Management monitors the City's revenues and expenditures, oversees budget transfers and adjustments, and reviews requests for City Council and Mayoral Actions for both the operating budget and the Capital Improvements Program (CIP). In addition, the Department develops and updates the Mayor's Five-Year Financial Outlook.

Risk Management:
- **Financial Risks**

The Risk Management Department is dedicated to effectively prevent, control, and minimize the City's financial risks while providing optimum services to City employees and the public through the centralized administration of employee benefits, loss control, and safety. The Risk Management Administration Fund is an Internal Service Fund that captures administrative costs related to workers' compensation claims management, employee (flexible) benefits, employee savings plan administration, safety and environmental health oversight, public liability claims management, loss recovery, and oversight of the insurance program for the City.

Independent Budget Analyst:
- **Budget and Policy Analysis**

In addition to the departments overseen by the CFO, the Office of the Independent Budget Analyst (IBA) assists the City Council with budgetary inquiries and in the making of budgetary decisions. The IBA provides information, analyses, and recommendations throughout the annual budget process, as well as for all financial and policy items submitted throughout the year for City Council, Council Committee, and Housing Authority consideration. Each fiscal year, the IBA reviews and evaluates the Mayor's Proposed Budget and Five-Year Financial Outlook, issuing reports that provide analysis and recommendations for City Council consideration.

Appendix C: Information Related to the City's Financial Statements

Comprehensive Annual Financial Reports (CAFRs)

The financial data used to calculate the ratios in this report originate from CAFRs from the City of San Diego and the benchmark cities. A CAFR is the official annual report of a state or local government. It includes introductory materials (such as a letter of transmittal and auditors' report), financial statements, supporting notes, supplementary schedules, and statistical data. Information from the annual financial reports provides consistent, reliable data because it conforms to generally accepted accounting principles and is audited under generally accepted government auditing standards. San Diego CAFRs used in this assessment were independently audited by Macias Gini & O'Connell LLP (MGO) Certified Public Accountants, and, in their opinion, the financial statements were fairly presented in all material respects.

Basic Financial Statements

The City's basic financial statements include three components:

1. Government-wide financial statements;
2. Fund financial statements; and
3. Notes to the financial statements.

1. Government-wide Financial Statements

The focus of the government-wide financial statements is reporting the operating results and financial position of the government as an economic entity. These statements are intended to report the City's operational accountability to its readers, giving information about the probable medium and long-term effects of past decisions on the City's financial position.

The statement of net position presents information on all of the City's assets, deferred outflows of resources, liabilities, and deferred inflows of resources, with the residual amount reported as net position. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of the City is improving or deteriorating.

The statement of activities presents information showing changes in the City's net position during the fiscal year. All changes in net position are reported when the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. The focus is on both gross and net costs of City functions, which are supported by general revenues. This statement also distinguishes functions of the City that are principally supported by taxes and intergovernmental revenues (governmental activities) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (business-type activities). The governmental activities and business-type activities together make up the primary government.

Governmental Activities
General Government and Support
Public Safety - Police
Public Safety - Fire, Life Safety, and Homeland Security
Parks, Recreation, Culture, and Leisure
Transportation
Sanitation and Health
Neighborhood Services
Debt - Cost of Issuance and Interest on Debt Service

Business-Type Activities
Sewer Utility
Water Utility
Airports
Development Services
Environmental Services
Golf Course
Recycling

Source: City Auditor generated.

2. Fund Financial Statements

The focus of the fund financial statements is on reporting of a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. All funds of the City can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements.

Proprietary fund statements provide the same type of information as the government-wide financial statements, only in more detail. The proprietary funds financial statements provide separate information for the Sewer and Water Utility funds, which are considered to be major funds of the City. Data for the non-major proprietary funds are combined into a single, aggregated presentation, and the internal service funds are combined into a single, aggregated presentation as well.

Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the City's operations. Fiduciary funds were therefore not included in the ratio analysis.

3. Notes to the Financial Statements

The notes to the basic financial statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

GASB Changes Related to Pension Reporting

The Government Accounting Standards Board (GASB) has issued at least three statements that will address how cities report postemployment benefits in the future.[15] According to the City Comptroller, under guidelines in effect through FY 2016, cities were required to include in the notes to the financial statements significant disclosures related to other postemployment benefit (OPEB) obligations, including the amount of the unfunded accrued liability as calculated by an actuary.

For example, the OPEB's unfunded actuarial accrued liability (UAAL) for San Diego of $538 million is disclosed in Note 12 of the FY 2016 CAFR. However, according to the City Comptroller, prior to FY 2017, the GASB standards did not allow inclusion of the UAAL as a long term liability in the financial statements. Rather, GASB required that only the cumulative underfunding amount of the annual required contribution be reported as liabilities in the financial statements.

Under the new GASB standards, cities will be required to report the OPEB liabilities, as defined by the standards, in the government-wide statement of net position and in the statement of net position of proprietary funds. These changes could significantly affect the total liabilities reported by cities in their financial statements.

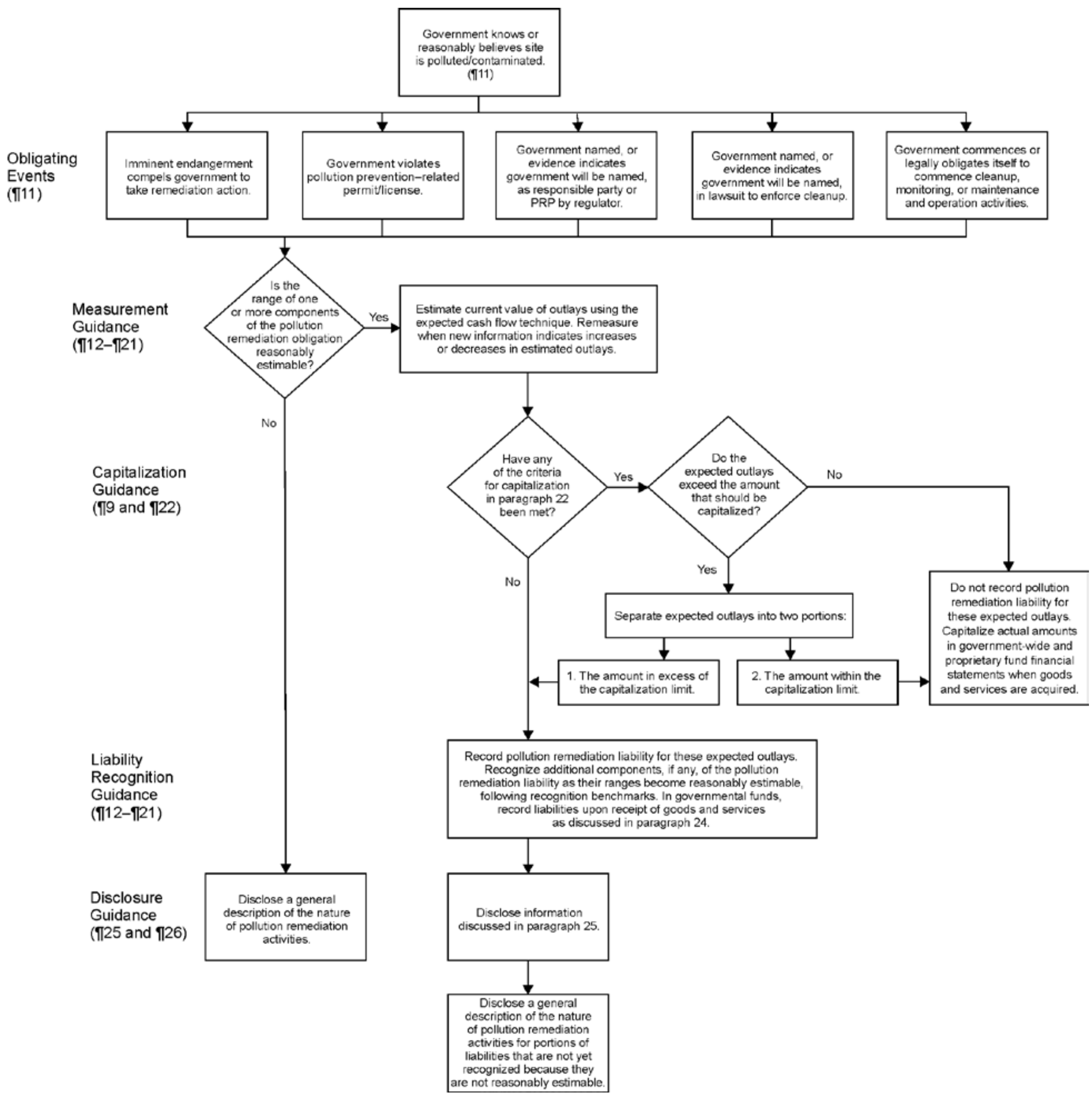
[15] GASB Statement Number 73, Accounting and Financial Reporting for Pensions and Related Assets That Are not with the Scope of Statement 68, and Amendments to Certain Provisions of Statements 67 and 68

GASB Statement 74, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans

GASB Statement 75, Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions

Appendix D: Contingent Liability Decision Matrix

GASB 49 provides the following diagram to assist agencies with determining when note disclosure is appropriate and when a liability should be recognized:



THE CITY OF SAN DIEGO

M E M O R A N D U M

DATE: June 15, 2018

TO: Eduardo Luna, City Auditor

FROM: Rolando Charvel, Chief Financial Officer

SUBJECT: Management Response to Performance Audit of the City's Financial Condition

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The purpose of this memorandum is to provide Management's response to the Audit Report entitled "Performance Audit of the City's Financial Condition."

The City Auditor's performance audit highlights continued and sustained strength in the City's financial condition. The Mayor and Council have consistently adhered to strong financial policies and practices allowing the City to continue to build upon its firm financial standing. In addition to maintaining cash reserves to protect the City from economic downturns and unforeseen events, the City adopts a structurally balanced budget each year, maintains strong expenditure controls, conducts long-term financial planning and adheres to responsible and equitable debt practices.

Financial reforms that will continue to benefit the City's financial condition include the closing of the City's pension system to all new hires except police officers and the creation of a 401(k)-style defined contribution plan that brings greater predictability and reduced risk to the City. They also include reforms to retiree healthcare benefits which significantly reduced the City's retiree healthcare obligations. The City has consistently made its full pension payment for over ten years and has prefunded retiree healthcare obligations through a trust fund.

The City Auditor's performance audit focuses on activity and balances from Fiscal Year 2016 and prior. Recent developments further showcase the City's strong financial performance. In 2017, the City's credit rating was upgraded by Fitch Ratings. Fitch Ratings commented on the City's "exceptionally strong gap closing capacity and satisfactory reserves [that] result from the City's strong general fund revenue performance, solid expenditure flexibility, healthy economy and tax base, conservative financial management policies, and strong financial planning and disclosure practices." In May 2018, Standard & Poor's placed the City on a positive outlook.

Other recent developments include the increase in reserve policy levels for the General Fund, from 14% to 16.7% of General Fund revenues, and establishment of a new pension stabilization reserve to reduce the impact of significant increases to the City's annual pension payment. Reserves continue to be funded each year at increased levels in accordance with the City's reserve policy.

Page 2
Eduardo Luna, City Auditor
June 15, 2018

It is important to note that even when comparing cities of similar population, there may be significant differences between them, including different functions performed for their residents, differences in socioeconomic, political and regulatory environments in addition to opportunities and limitations afforded by their geographic location and natural environment. There are also differences relating to revenue or debt raising ability among local agencies in California compared to localities in other states.

The metrics included in this report are based on formulas that provide a high-level view of each city's financial condition. A more complete assessment can only be achieved through a careful review and understanding of each city's annual financial statements and note disclosures. There could be significant transactions, such as the construction of a large capital project or the receipt of a large legal settlement that could impact the result of some of the metrics in any given year.

I would like to thank Mayor Kevin Faulconer and the City Council for adopting and maintaining strong financial policies, including the consistent funding of the pension system and the growth and maintenance of healthy reserves. I would also like to thank the finance team for their tireless work overseeing City finances and establishing best financial practices in their respective departments. We recognize the important contributions made by the Office of the Independent Budget Analyst and their collaboration and input in developing financial policies. Finally, I thank the City Auditor's Office for their work during this financial analysis and for their contributions to improve City operations.

Rolando Charvel
Chief Financial Officer

RC/rc

cc: Kris Michell, Chief Operating Officer
Stacey LoMedico, Assistant Chief Operating Officer
Andrea Tevlin, Independent Budget Analyst
Jessica Lawrence, Director of Finance Policy and Council Affairs, Office of the Mayor
Tracy McCraner, City Comptroller and Financial Management Department Director
Lakshmi Kommi, Director, Debt Management Department
Gail Granewich, City Treasurer
Julio Canizal, Director, Risk Management Department
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