PERFORMANCE AUDIT OF THE CITY'S FINANCIAL CONDITION

San Diego's Financial Condition Has Shown Considerable Improvement from Fiscal Years 2011 to 2014

Office of the City Auditor

City of San Diego

OCA

Independent • Objective • Accurate

August 2015

This Page Intentionally Left Blank

THE CITY OF SAN DIEGO

August 6, 2015

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 2015 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 on pages 11 and 34.

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

Respectfully submitted,

Eduardo Luna
City Auditor

cc: Scott Chadwick, Chief Operating Officer
Stacey LoMedico, Assistant Chief Operating Officer
Mary Lewis, Chief Financial Officer
Jan Goldsmith, City Attorney
Rolando Charvel, City Comptroller
Andrea Tevlin, Independent Budget Analyst
Brian Pepin, Director of Council Affairs
Tracy McCraner, Director, Financial Management Department

This Page Intentionally Left Blank

Table of Contents

Results in Brief

Over the last decade, the City of San Diego's (City) financial health has been the subject of continuous scrutiny by the public, news media, and policymakers. 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 2005–FY 2014 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 results for the City of San Diego show remarkable improvement in the City's financial health. San Diego's financial condition has improved significantly and has been among the best when compared to the six other cities with comparable populations for eight of the last 10 years. San Diego scored significantly higher (at least double) than the next highest city from FY 2012 through FY 2014. Ratios for debt coverage, multiple revenue sources, solvency, and liquidity were strong in 2014, and the other ratios all scored well when compared to the other six cities. In addition, eight of ten ratios had positive trend lines, with liquidity showing marked improvement from FY 2005 to FY 2014.

[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).

The City of San Diego has experienced financial challenges in recent history, 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 City of San Diego has high scores relative to these benchmarked cities as a result of the Mayor and City Council implementing and adhering to strong fiscal policies[3] and procedures, including reserve policies, and sound budgetary practices and expenditure controls. The City implemented a reserve policy (and increased General Fund policy reserve levels in 2014) and steadily funded reserves to policy targets. Expenditure control through monthly reports and quarterly budget monitoring, midyear budget adjustments and the Five Year Financial Outlook are some of the strong fiscal practices that have been implemented to improve the fiscal strength of the city.

Going forward, it will be important to update and 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. It is also important to note that financial analysis is an iterative process. 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 policymakers and stakeholders.

[3] The City's Budget Policy, Reserve Policy, Debt Policy, and Investment Policy.

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 local and regional economic disruptions; and
- Meet the demands of natural 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 now doing, whether there are reserves or other vehicles 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 it cannot, it is probably experiencing or can anticipate financial problems.

Historical Context

The City of San Diego (City) has experienced significant financial challenges in recent history 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, 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 2014 through 2016, 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

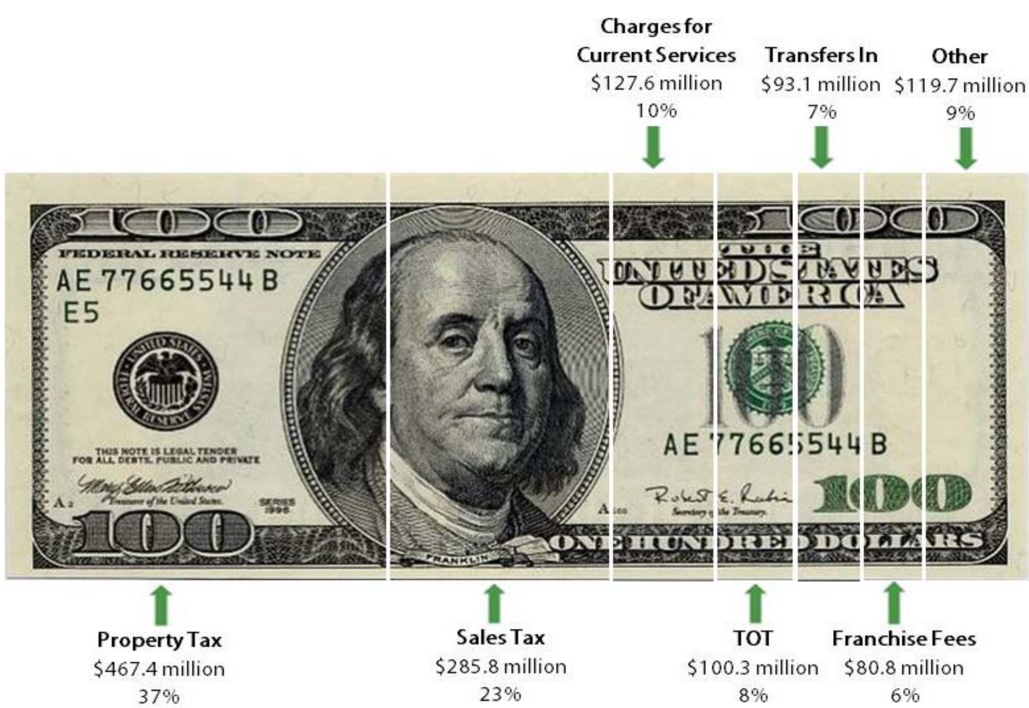
The City's FY 2016 Proposed Budget totals $3.2 billion and incorporates projections for an improved economic outlook based on the continuing trend of increases in median home prices, home sales, consumer spending, tourism, business travel, and employment levels. The Proposed Budget includes $1.3 billion for General Fund operations, $1.6 billion for operations of the City's Enterprise Funds and all other funds, and $338 million for capital improvement projects across the City.

General Fund Revenue Sources

In the City's FY 2016 Proposed Budget, the General Fund's largest 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 2016 Proposed Budget, General Fund Revenue



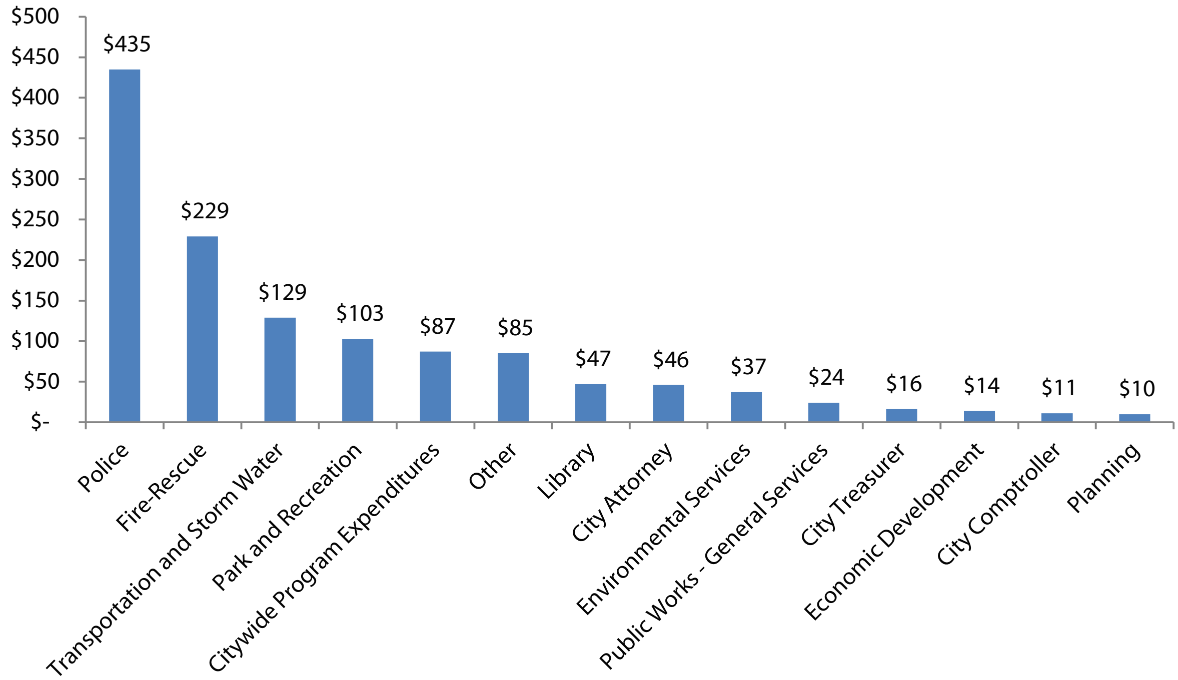
Source: City Auditor generated. All exhibits in this report are City Auditor generated, unless noted otherwise.

General Fund Expenditures

The City's FY 2016 Proposed Budget reflects General Fund expenditures totaling $1.28 billion and 7,221 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 2016 Proposed 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 2016 Proposed Budget, General Fund Expenditures by Department (in Millions)



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

Source: FY 2016 Proposed Budget.

Debt Obligations

The outstanding principal for the City's existing long-term debt obligations[4] as of June 30, 2015 are as follows:

- General Fund backed Lease-Revenue Obligations: $558 million
- Public Utilities-Water System Obligations: $752 million
- Public Utilities-Wastewater (Sewer) System Obligations: $976 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

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**.

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.[5]

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 considered 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 disparate 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.

[4] 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.

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

The 10-point test begins with the calculation of 10 ratios for the government of interest pulled from Comprehensive Annual Financial Reports (CAFRs)[6] 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**.

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 Revenues	Flexibility of City's revenues based upon reliance on intergovernmental aid, including grants.
	6. Governmental Activities 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.)

In using the modified 10-point test to assess the City's financial condition, we selected cities for comparison based on government type and population size. We selected the three US cities with populations immediately greater than San Diego (Philadelphia, Phoenix, 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.[7]

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

[7] 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 trended upward.

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	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total
Short-Run Financial Position	0	0	1	1	1	1	1	1	1	1	**8**
Liquidity	-1	-1	-1	-1	0	0	1	2	1	2	**2**
Financial Performance	1	1	1	2	1	1	0	2	2	2	**13**
Solvency	1	1	1	1	1	1	1	2	2	2	**13**
Primary Government Revenues	1	1	2	2	1	2	2	2	2	2	**17**
Governmental Activities Revenues	1	1	1	1	1	0	0	1	2	2	**10**
Primary Government Debt Burden Per Capita	2	2	2	2	2	2	2	2	2	2	**20**
Governmental Funds Debt Coverage	1	2	1	2	2	2	1	2	2	2	**17**
Enterprise Funds Debt Coverage	2	2	2	2	2	2	2	2	1	1	**18**
Net Change in Capital Assets	1	1	0	-1	0	0	-1	-1	1	1	**1**
Annual Totals	**9**	**10**	**10**	**11**	**11**	**11**	**9**	**15**	**16**	**17**	

San Diego's highest scores for the 10-year period were related to debt, 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.

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 and 2014. Even though the City improved significantly, the ratios for San Diego's net change in capital assets were well below benchmark cities average, except in FY 2013. This made that ratio the least favorable for San Diego.

Analyses of ratios provide City leaders with the opportunity to address the risk of potentially negative future outcomes before they become critical situations. The liquidity ratio helps assess the ability of the local government to sustain a strong financial position. Liquidity represents a government's ability to pay its short-term obligations. A high ratio suggests a greater ability to pay off bills as they become due.

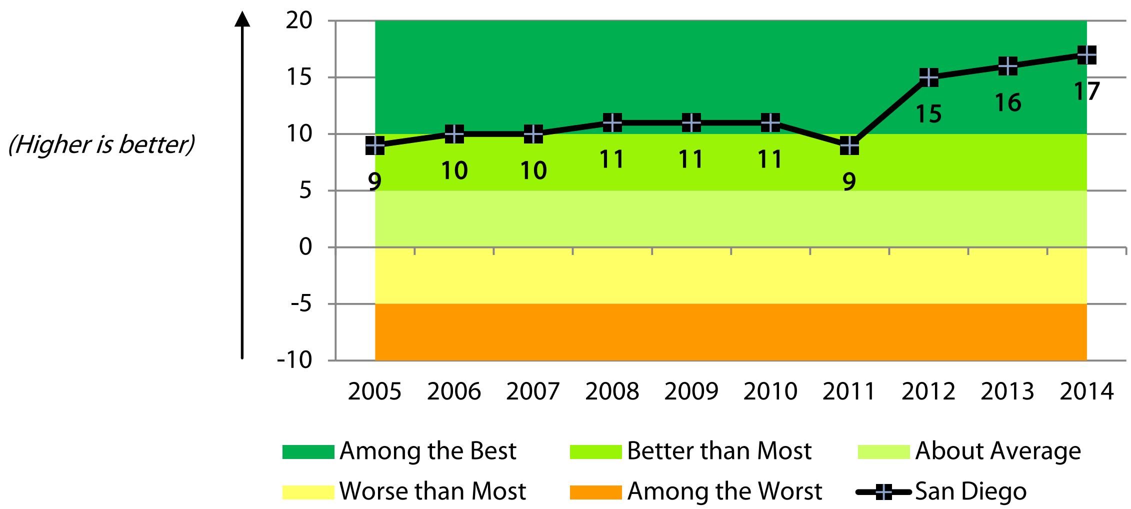
The capital assets ratio measures the change of the net value of capital assets. A high ratio suggests a government is keeping pace, on average, with the aging of its capital assets and replenishing them. A positive percentage change suggests capital assets are being replenished; a negative number suggests they are being depleted. The City has an extensive Capital Improvement Program Budget, and this ratio is useful in comparing the net rate of investment versus depreciation. Please note that this ratio measures an overall or average change, rather than the condition of individual assets. Therefore, caution must be exercised when using this ratio, since it is not intended to evaluate capital asset condition. Moreover, the addition or replacement of a large infrastructure asset could affect the ratio in a given year.

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**.

Exhibit 5

San Diego 10-Point Test Scores

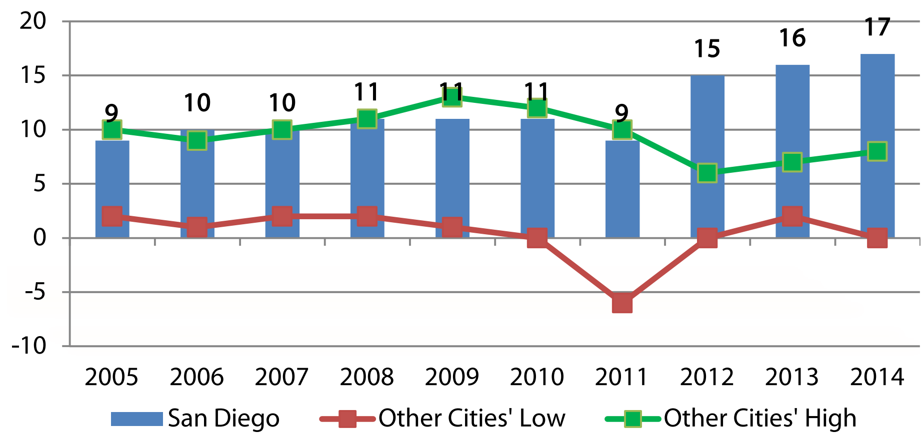


San Diego Score Compared to Benchmark Cities

San Diego's FY 2014 score of 17 exceeded the other cities' scores, which ranged between a high of 8 and low of 0. 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' scores for FY 2012 through 2014. **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



San Diego Ranked to Benchmark Cities

San Diego was ranked either first or second for all the years during the test period except one—in FY 2005, the City ranked third among the benchmark cities. **Exhibit 7** displays the City's annual rank.

Exhibit 7

San Diego's Annual Rank

Rank	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										17
2nd										8
3rd										8
4th										3
5th										3
6th										1
7th										0

Chief Financial Officer Remarks Related to the City's Scores

According to the City's Chief Financial Officer:

> The City of San Diego has high scores relative to these benchmarked cities as a result of the Mayor and City Council implementing and adhering to strong fiscal policies[8] and procedures, including reserve policies, and sound budgetary practices and expenditure controls. The City implemented a reserve policy (and increased General Fund policy reserve levels in 2014) and steadily funded reserves to policy targets. Expenditure control through monthly reports and quarterly budget monitoring, midyear budget adjustments and the Five Year Financial Outlook are some of the strong fiscal practices that have been implemented to improve the fiscal strength of the city.
>
> The implementation of an enterprise resource planning system to establish controls over financial reporting and business processes has improved the quality and availability of financial data for policy decisions and internal and external reporting.
>
> Credit rating agencies such as Standard and Poor's and Moody's have recently remarked in rating reviews on the City's 'very strong liquidity', 'strong financial practices', 'strong oversight of budget to actual expenses during the year', and 'reserves preservation'.
>
> The trend has been positive in nearly all the scores showing the progressive improvements management and elected officials have made to strengthen the City's fiscal position. The Mayor and City Council have worked cooperatively over the past several years to adopt these sound fiscal policies and budgetary practices via resolutions and ordinances, and most importantly, have consistently adhered to those policies and practices, including the disciplined funding of the pension system and other post-employment benefits, and the growth and maintenance of healthy reserves.

The following section provides more detailed information and analysis for each ratio in the 10-point test.

[8] The City Budget Policy, Reserve Policy, Debt Policy, and Investment Policy.

Ratio 1: Short-Run Financial Position

Formula = Unreserved General Fund Balance ÷ General Fund Revenues

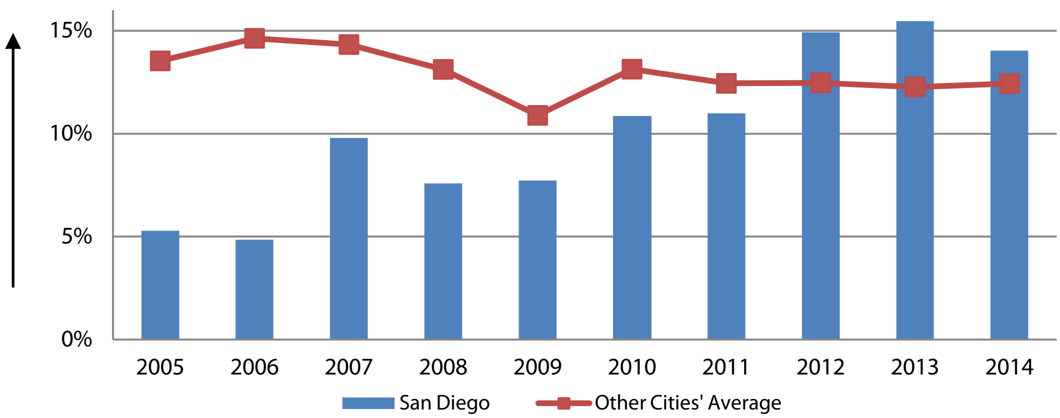
The short-run financial position ratio measures the City's ability to handle unforeseen resource needs over the short-term.

The City of San Diego had $177 million in Unassigned (Unreserved) General Fund Balance that equaled 14 percent of General Fund Revenues at the end of FY 2014. The City improved performance from a low of 4.8 percent in FY 2006 to a high of 15.5 percent in FY 2013. This means that the City's FY 2014 Unreserved General Fund balance would be sufficient to keep the City's basic functions running for approximately 51 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.



During the first half of the 10-year period, San Diego's ability to meet short-term needs was well below the benchmark cities' average. For example, San Diego's ratio was 9.8 percentage points below the average in FY 2006 and 4.5 percentage points below the average for the other cities in FY 2007. Conversely, San Diego's ratio improved during the latter half, with the last three years showing better-than-average ratios. This improvement was influenced by San Diego's reserve policy, created in accordance with Charter Section 91 and revised in 2011. A goal of the policy was to have a minimum of 8 percent of annual General Fund revenues held in the General Fund Reserve by FY 2012.

Exhibit 2: San Diego Ranking to Benchmark Cities

Rank	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										22.6%
2nd										16.6%
3rd										16.5%
4th										**14.0%**
5th										11.8%
6th										6.4%
7th										0.7%

San Diego's ranking was stable, remaining middle-of-the-road compared to the other cities for the entire 10-year period. San Diego was ranked 5th in the first two years, and improved to 4th for seven of the remaining eight years.

Ratio 2: Liquidity

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

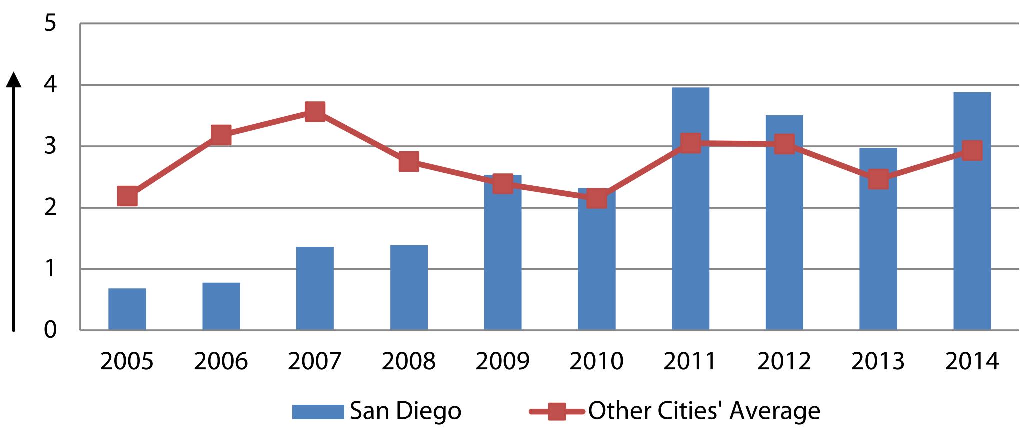
The liquidity ratio measures the City's ability to meet its short-term obligations with current assets. Although liquidity changes constantly, an annual year-end look is useful because, unless the government makes major changes in receipt of revenues or disbursement of funds patterns, the City should 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 10 years from a low of 0.7 in FY 2005 to 3.9 in FY 2014. This means that the City had the capacity to pay current bills almost four times over in FY 2014. At a ratio of 3.9, San Diego's FY 2014 cash and investments were $80 million greater than—or liabilities were $30 million less than—the average of benchmark cities.

Exhibit 1: Liquidity

(Higher is better)

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



The City's liquidity ratio improved significantly during the 10-year period and was consistently above the average for benchmark cities since FY 2009. This suggests that San Diego's capacity to pay current bills is better than most of the benchmark cities.

Exhibit 2: San Diego Ranking to Benchmark Cities

Rank	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										4.1
2nd										**3.9**
3rd										3.8
4th										3.7
5th										2.9
6th										2.3
7th										0.9

At the beginning of the 10-year period, San Diego was ranked 6th and 7th, improving to a rank of 3rd in FY 2011. San Diego maintained consistent positions of 2nd or 3rd for the remaining years.

Ratio 3: Financial Performance

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

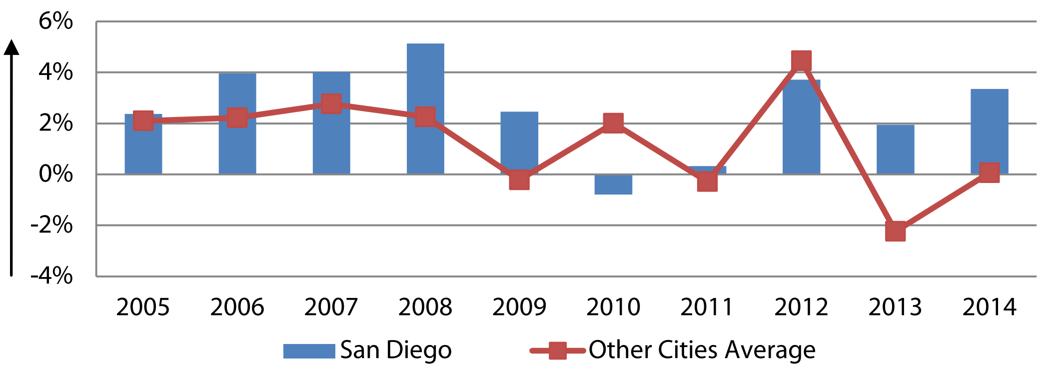
The financial performance ratio measures the rate at which a city's financial resources are growing or declining. Utilizing the change in net assets for governmental activities, this ratio demonstrates how well the City was able to pay expenses with revenues from that year. In other words, the ratio 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 10-year period ranged from a high of 5.1 percent in FY 2008 to a low of -0.8 percent in FY 2010. The City's revenues exceeded expenses by about $161.8 million in FY 2014, which means net assets increased by 3.4 percent.

Exhibit 1: Financial Performance[9]

(Higher is better)

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



San Diego's ratio was more than three percentage points above the average for benchmark cities in FY 2013 and FY 2014, which is an improvement from FY 2012 when the ratio was slightly below average. The City's financial performance was relatively stable, with ratios varying by only 5.9% over the ten-year period—the least among all cities. (Benchmark cities' financial performance ratios varied by 23.8%, on average). The ratios of the benchmarked cities ranged from a high of 29.4% to a low of -50.9%.

Exhibit 2: San Diego Ranking to Benchmark Cities

Rank	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										3.6%
2nd										**3.4%**
3rd										1.9%
4th										1.5%
5th										-2.9%
6th										-3.8%
7th										-9.9%

San Diego was ranked 2nd or 3rd for all years except FY 2005 when it was ranked 4th, and FY 2011 when it was ranked 5th among the benchmark cities.

[9] Philadelphia was removed from the average of other cities because their ratios significantly skewed the averages for 5 of 10 years.

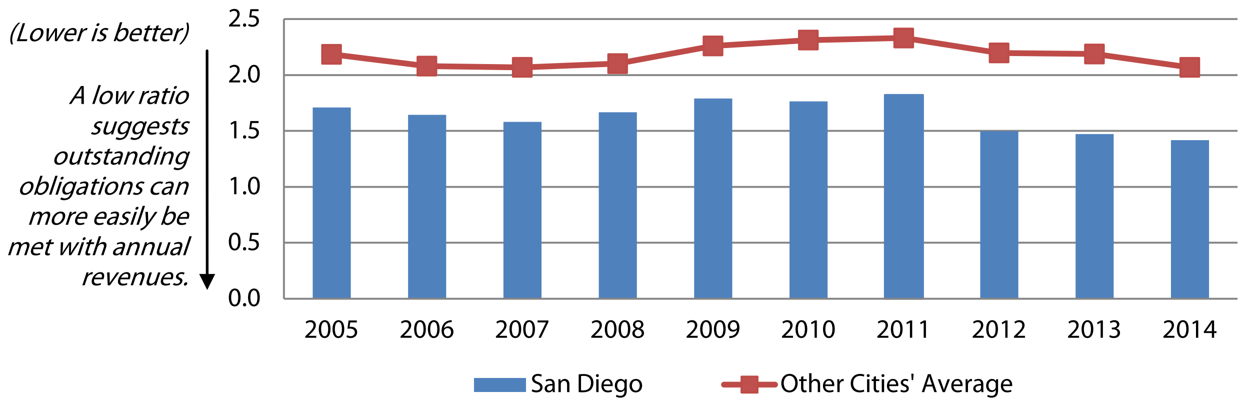
Ratio 4: Solvency

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 has been relatively stable and improved slightly over the analysis period, ranging from a high of 1.8 in FY 2009 through 2011 to a low 1.4 in FY 2014. This means that the City's liabilities were 40 percent greater than the sum of annual revenues. In FY 2014, the City would have needed almost $1.2 billion of additional revenue to liquidate all of its outstanding long-term obligations.

Exhibit 1:Solvency



San Diego's solvency results could be considered positive because the ratio has been decreasing since FY 2012 and because the ratios were consistently below benchmark cities. Benchmark cities' ratios ranged from a high of 3.6 to a low of 1.3 during the 10-year period.

Exhibit 2: San Diego Ranking to Benchmark Cities

Rank	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										1.38
2nd										**1.42**
3rd										1.84
4th										2.08
5th										2.17
6th										2.29
7th										2.64

San Diego has been consistently ranked above average for the 10-year period compared to the benchmark cities, improving from the 3rd ranking during the first seven years to 2nd in the last three years.

Ratio 5: Primary Government Revenues

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

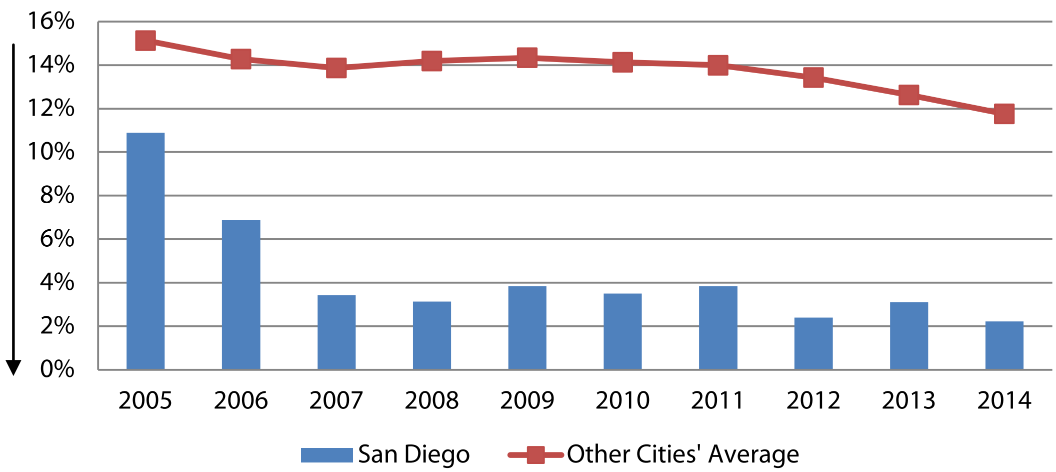
The primary government revenues ratio measures the flexibility of the City's revenues. The ratio considers different sources of revenues of the primary government, including business-type activities. Intergovernmental aid is revenue generated from other government entities and includes grants. Reliance 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.

San Diego's primary government revenues ratio has improved by trending downward over the review period, from 11 percent in FY 2005 to 2 percent in FY 2014. At the end of FY 2014, the City relied only on about $62.8 million of intergovernmental aid, which is only two 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.



San Diego's two-percent ratio in FY 2014 was almost 10 percentage points below comparison cities, showing that the City is not as heavily reliant on intergovernmental aid as the benchmark cities. San Diego's ratios consistently remained below the average of benchmark cities during the entire review period.

Exhibit 2: San Diego Ranking to Benchmark Cities

Rank	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										1.5%
2nd										**2.2%**
3rd										3.3%
4th										6.1%
5th										8.4%
6th										20%
7th										31%

While the ranking varied over the initial five years, the City maintained a 2nd place ranking for the last five 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

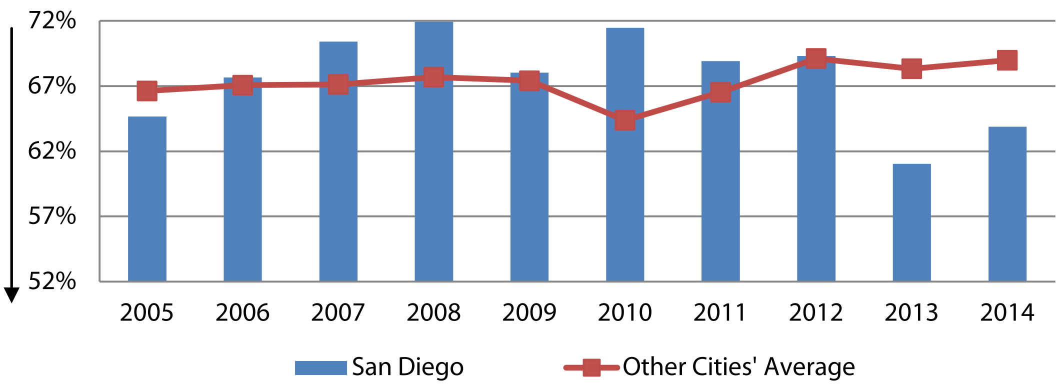
The governmental activities revenues ratio measures the degree to which governmental activities are supported by taxes and other general revenues. This ratio shows the extent to which governmental activities' functions and programs are self-financed, or the degree to which they depend on financing from 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's governmental activities have maintained relatively stable taxpayer support, ranging between 61 percent and 72 percent during the 10-year review period. In FY 2014, governmental activities generated almost $592 million in revenues, compared to net expenses of over $1 billion. This means 64 percent of expenses had to be funded through taxes and other general revenues. San Diego has reduced reliance on general tax support to 61 percent and 64 percent during FY 2013 and FY 2014 respectively from 69 percent in FY 2012.

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.



Although San Diego's ratio increased at the beginning of the review period, the overall trend is positive with downward movement, meaning the City's services are more self-reliant than in prior years. The trend is attributed primarily to the decreases in FY 2013 and FY 2014, since six of the prior years were worse than the average for benchmark cities.

Exhibit 2: San Diego Ranking to Benchmark Cities

Rank	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										61%
2nd										**64%**
3rd										65%
4th										67%
5th										70%
6th										73%
7th										78%

San Diego's ranking has hovered around the middle of the benchmark cities during the review period. In FY 2013 and 2014, the City's ranking improved to 2nd from a low of 5th.

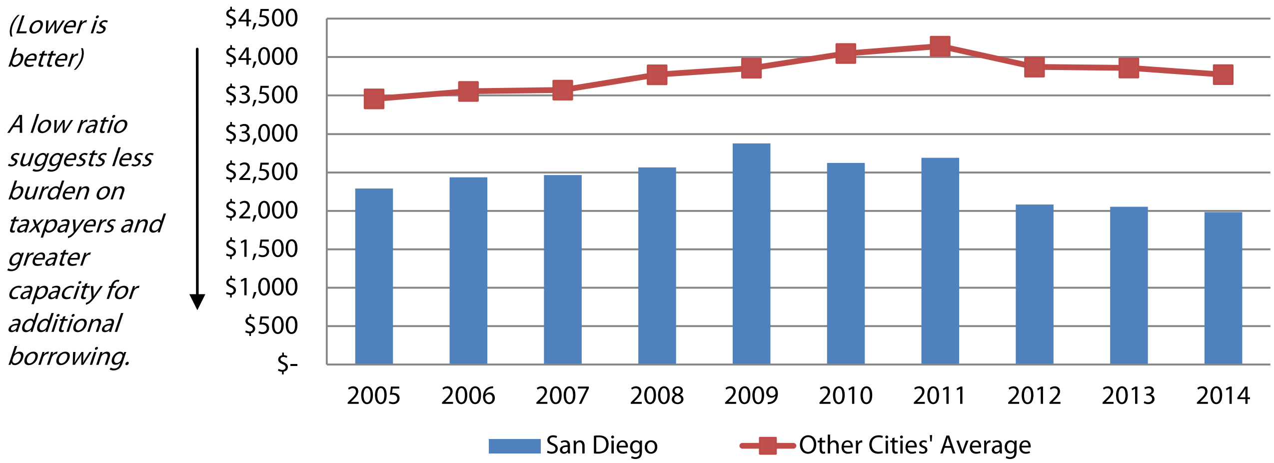
Ratio 7: Primary Government Debt per Capita

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

The primary government debt burden per capita ratio identifies the level of long-term debt[10] burden on the City's residents. If long-term debt is increasing as population stabilizes or declines, debt levels may be reaching or exceeding the City's ability to pay. A low ratio suggests there is less debt burden imposed on taxpayers and a greater potential capacity for additional borrowing.

In FY 2014, the total outstanding debt for the City of San Diego was almost $2.7 billion. The City's per capita debt burden has trended downward, from $2,876 in FY 2009 to $1,984 in FY 2014.

Exhibit 1: Primary Government Debt per Capita



San Diego has maintained a level of long-term debt well below the average of benchmark cities. For example, the average ratio for benchmark cities in FY 2014 for debt per capita was $3,773 and the highest ratio for a benchmark city was $6,689. 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.

Exhibit 2:San Diego Ranking to Benchmark Cities

Rank	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										**$1,984**
2nd										$2,053
3rd										$2,757
4th										$3,289
5th										$3,465
6th										$4,384
7th										$6,689

San Diego consistently ranked 2nd among the benchmark cities for debt burden per capita until FY 2014. Increases in the debt burden during the beginning of the review period did not affect the City's ranking because the benchmark cities also experienced

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

similar debt burden increases. In FY 2014, San Diego's debt per capita dropped by $69, causing the City to move into first place.

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.

Primary Government Liabilities per Capita Ratio

Formula = Total Primary Government Long-Term Liabilities ÷ Population

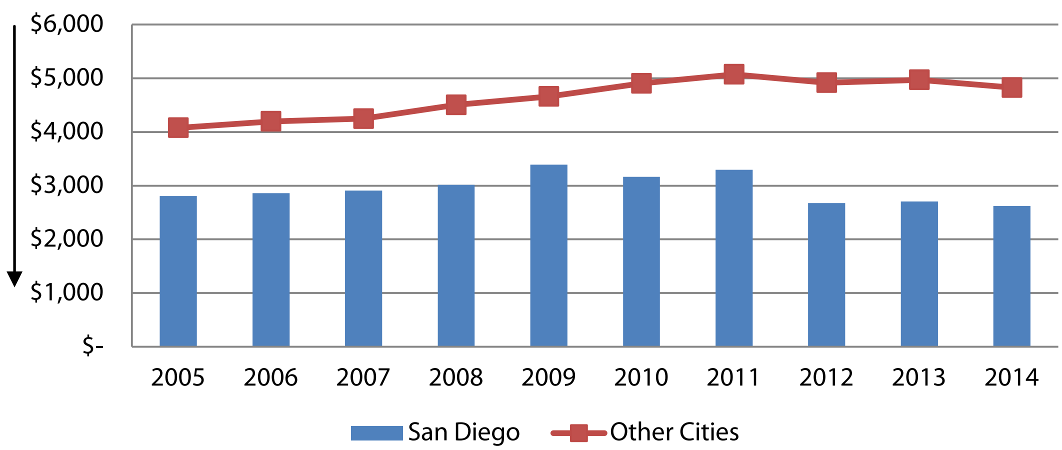
This ratio measures the burden on City residents for primary government long-term liabilities. The per capita measures liability increases related to changes in population size. As population increases, service demand, capital needs and, hence liabilities would be expected to increase. If, however, long-term liabilities increase as population stabilizes or declines, the liabilities may exceed city's ability to pay.

In FY 2014, the total long-term liabilities for the City of San Diego were over $3.5 billion. The long-term liabilities per capita were $2,621, only $637 greater than the debt per capita of $1,984. The City's per capita liability burden has improved through a downward trend, from $3,390 in FY 2009 to $2,621 in FY 2014.

Exhibit 1: Primary Government Liabilities per Capita

(Lower is better)

A low ratio suggests suggests less future burden on taxpayers.



San Diego has maintained the level of long-term liabilities well below the average of benchmark cities.

Exhibit 2: San Diego Ranking to Benchmark Cities

Rank	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										$2,399
2nd										**$2,621**
3rd										$3,495
4th										$4,493
5th										$4,626
6th										$5,664
7th										$8,274

San Diego has consistently ranked 2nd among the benchmark cities for long-term liability burden per capita. Increases in the per capita burden during the beginning of the review period did not affect the ranking due to similar increases by benchmark cities.

This report did not compare San Diego's unfunded actuarial accrued liabilities (UAAL), for pension and other postemployment benefits (OPEB), to other cities. San Diego's UAAL of $2.2 billion for the pension plan is disclosed in Note 11 of the FY 2014 CAFR. However, according to the City Comptroller, prior to FY 2015, the Governmental Accounting Standards Board (GASB) standards did not allow inclusion of the UAAL as a long term liability in the financial statements. The GASB has issued at least five statements that will address how cities report pension and postemployment benefits in the future. The City Comptroller notes that these changes could significantly affect the total liabilities reported by cities in their financial statements. **Appendix C** provides more information about the impending GASB changes.

Ratio 8: Government Funds Debt Coverage

Formula = Debt Service Expenditures ÷ Noncapital Governmental Funds Expenditures

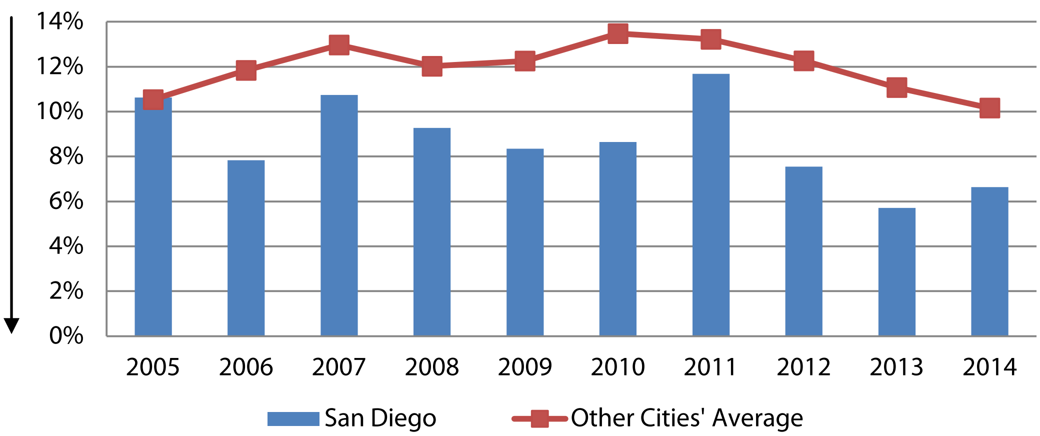
The government funds debt coverage ratio measures debt service expenditures in relation to operating costs. These expenditures are the amount of principal and interest on long-term debt and the amount of interest on short-term debt that a city must pay each year. Debt service expenditures reduce spending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

During FY 2014, San Diego's debt service expenditures amounted to $103 million or 6.6 percent of operating expenditures. During the 10-year review period, San Diego's government funds debt coverage ratio ranged from a high of 11.7 percent in FY 2011 to a low of 5.7 percent in FY 2013 and stayed below the average of benchmark cities for the vast majority of the period. Despite fluctuations, the ratio for San Diego shows an overall downward trend during the ten-year period.

Exhibit 1: Government Funds Debt Coverage

(Lower is better)

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



San Diego's FY 2014 ratio was 3.5 percentage points below the average of benchmark cities and 8.5 percentage points below the highest benchmark ratio. During the last nine 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	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										4.0%
2nd										**6.6%**
3rd										7.7%
4th										9.4%
5th										9.8%
6th										15.0%
7th										15.1%

The City consistently remained in 2nd or 3rd ranking when compared to the other cities during the entire 10-year period. In FY 2014, San Diego's ratio was 2.6 percentage points below the highest ranked city and 8.5 percentage points above the lowest ranked city.

Ratio 9: Enterprise Funds Debt Coverage

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

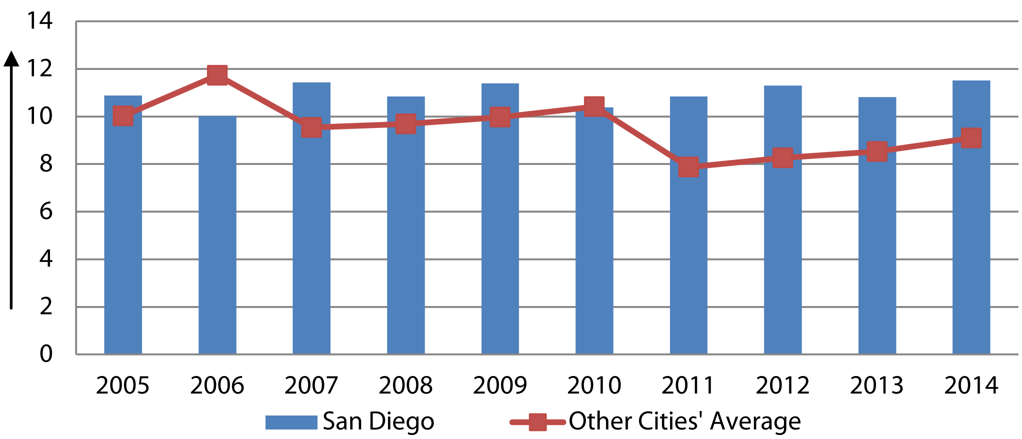
The enterprise funds debt coverage ratio indicates the sufficiency of resources available to repay business-type activity debt. The City uses enterprise funds to account for its Sewer Utility, Water Utility, Airports, Development Services, Environmental Services, Golf Courses, and Recycling. These business-type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

The City of San Diego has maintained a relatively consistent ratio, with a slight increase over the review period. The City's ratio was the lowest in FY 2006 at 10 and the highest in FY 2014 at 11.5. San Diego paid almost $89 million for enterprise fund interest expense during FY 2014.

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.



San Diego's ratio has been relatively favorable compared to the average of benchmark cities, improving significantly in recent years. The San Diego ratios were at least two points higher than the average of other cities in FY 2011 through FY 2014. This suggests that San Diego is in a better position to repay enterprise fund debt than other benchmark cities.

Exhibit 2:San Diego Ranking to Benchmark Cities

Rank	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										13.4
2nd										12.2
3rd										**11.5**
4th										9.1
5th										7.4
6th										6.7
7th										5.9

San Diego was ranked 2nd among benchmark cities during the beginning of the review period and has fluctuated from a 1st to 3rd ranking in recent years. The San Diego ratio has remained fairly consistent over the ten year period, but the ranking changed in relation to increases by two other cities.

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 of the 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. Please note that this ratio measures an overall or average change, rather than the condition of individual assets.

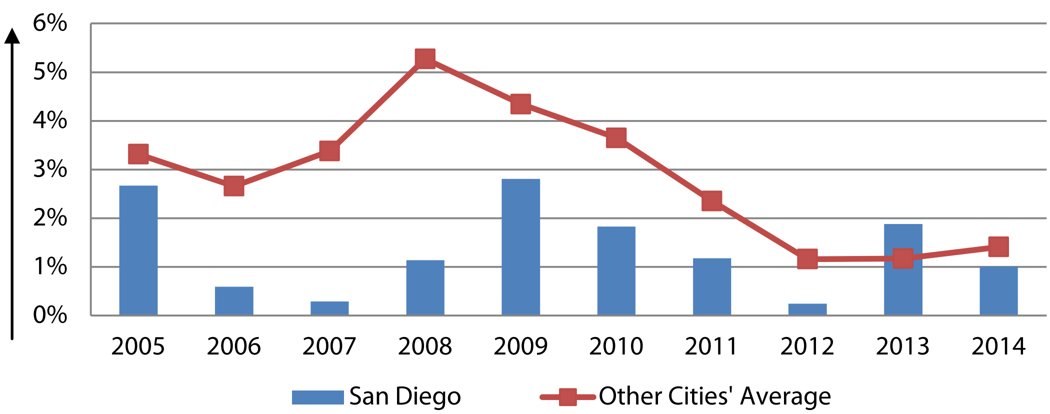
For example, the replacement or addition of expensive infrastructure assets may inadvertently suggest that substantial replenishment has occurred when in reality most capital assets have not been improved. Therefore caution must be exercised when using this ratio, since it is not intended to evaluate the capital assets' condition.

Overall, the City of San Diego's ratio has trended downward slightly over the 10-year review period. The City's lowest ratio was 0.2 percent in FY 2012, followed by an increase to 1.9 percent in FY 2013. The City's highest ratio was 2.8 percent in FY 2009.

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.



San Diego's ratios were well below benchmark cities' average except in FY 2013. In FY 2014, the City was 0.4 percentage points below the average of other cities. In FY 2014, the ending net value of primary government capital assets would have had to increase by about $40 million for San Diego to meet the average of the benchmark cities.

Exhibit 2:San Diego Ranking to Benchmark Cities

Rank	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1st										4.4%
2nd										4.0%
3rd										3.4%
4th										**1.0%**
5th										0.9%
6th										-0.3%
7th										-3.9%

The City of San Diego ranked as high as third among the benchmark cities in FY 2005, 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 the test.

Conclusion

The City of San Diego's overall financial condition—in the areas of financial position, revenues, and debt—has improved markedly over the last ten years, especially when compared to other cities of similar population size. Our audit results show that San Diego is in a stronger position today than it was ten years ago. While our financial analysis is limited, our results suggest that the City is in a strong position to finance its services on a continuing basis and poised to meet the demands of natural 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 that helped the City overcome a point of crisis.

City leaders and employees at all levels will need to continue the strong 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 and regularly evaluating the City's financial condition will raise important questions that policymakers and stakeholders must consider in the decision-making process. 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 2015 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).[11] 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.

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.

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

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

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 (2005 through 2014), 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[12] 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, 2014.

City Name	Population Estimate (2014)
Philadelphia	1,560,297
Phoenix	1,537,058
San Antonio	1,436,697
San Diego	**1,381,069**
Dallas	1,281,047
San Jose	1,015,785
Austin	912,791

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 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

[12] 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 3,928,864 and San Francisco with 852,469.

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
Comparative data compiled under consistent accounting principles and audited under Government Auditing Standards.
Ratios developed independent of city management and provides an independent view of the City's finances.
The City's results are contextualized by comparison to cities of similar size.
The City's results are contextualized by comparison over a 10 year period.

Limitations
Analysis provides a broad overview rather than detailed analysis.
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.
Provides historical analysis rather than projections of future condition.
Results are a relative comparison, but do not provide the optimal ratio value a city should strive for.

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 departments 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.

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

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 five statements that will address how cities report pension and postemployment benefits in the future.[13] According to the City Comptroller, under guidelines in effect through FY 2014, cities were required to include in the notes to the financial statements significant disclosures related to pension and other postemployment benefit (OPEB) obligations, including the amount of the unfunded accrued liability as calculated by an actuary. For example, the pension's unfunded actuarial accrued liability (UAAL) for San Diego of $2.2 billion is disclosed in Note 11 of the FY 2014 CAFR. However, according to the City Comptroller, prior to FY 2015, 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 pension and 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.

[13] GASB Statement Number 67, Financial Reporting for Pension Plans (Amends Statement 25)

GASB Statement Number 68, Accounting and Financial Reporting for Pensions (Amends Statement 27)

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

THE CITY OF SAN DIEGO

MEMORANDUM

DATE: July 30, 2015

TO: Eduardo Luna, City Auditor

FROM: Mary Lewis, Chief Financial Officer Mary Lewis

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

---

This independent evaluation of San Diego's financial position validates the achievements of the Mayor, City Council and management to restore the City's fiscal health and get San Diego back on track. This is a high achievement for San Diego. On a ten point score, the City comes out as among the best on eight scores and better than most on two.

The City must remain faithful to fiscal reforms and financial best practices in order for the City's financial health to remain strong, and this administration is committed to doing just that.

I want to thank City Auditor Eduardo Luna and the audit team, especially the audit manager Chris Kime, for sharing metrics, data and early results and giving the finance branch the opportunity to comment.

Mary Lewis
Chief Financial Officer

ML/cb

cc: Scott Chadwick, Chief Operating Officer
Stacey LoMedico, Assistant Chief Operating Officer
Matt Awbrey, Deputy Chief of Staff, Office of the Mayor
Amelia Brazell, Director, Communications Department
Rolando Charvel, City Comptroller
Tracy McCraner, Director, Financial Management Department
Chris Kime, Audit Manager, Office of the City Auditor