Audit of Internal Control Remediation Related to the San Diego City Employees Retirement System

Audit Committee Meeting

October 6, 2008

SDCERS Internal Control Remediation

Audit Objective

- We have an ongoing audit to verify that adequate corrective actions have been taken by management to remediate internal control weaknesses identified by the Kroll report and other audit reports.
- As we perform testing and identify items needing further remediation, we issue an audit report.
- The subject of this report is our testing of the corrective actions taken for control weaknesses pertaining to the San Diego City Employees Retirement System (SDCERS).

SDCERS Internal Control Remediation

Audit Approach (Methodology)

- Reviewed Agendas and Minutes to various SDCERS Board and City Council Meetings.
- Reviewed various articles of the City Charter, the Municipal Code, SDCERS Board Rules, Contracts, CAFRs and Actuary Reports.
- Met with various City staff and SDCERS CFO and Internal Auditor to discuss the remediation efforts.
- Contacted the City's Independent Consultant, Stanley Keller, for opinions on two items.

SDCERS Internal Control Remediation

Audit Approach (continued)

We reviewed:

- SDCERS written procedures.
- The Pension Reform Committee's Final Report.
- The San Diego Charter Review Committee's Final Report.
- The City of San Diego Five Year Financial Outlook plan.

SDCERS Internal Control Remediation

Audit Results

- We tested 30 items reported as remediated to verify that the actions taken by SDCERS and City management corrected the weaknesses identified.
- Of the 30 items tested, 16 items were the responsibility of SDCERS, and 14 items were the responsibility of City Management.

SDCERS Internal Control Remediation

Audit Results (continued)

Of the 30 control weaknesses tested:

- We found that SDCERS has fully remediated 12 items as recommended and needs to take further actions on 3 items.
- We also found that 1 item was not implemented by SDCERS, but we are not offering a recommendation for further action on this item.
- We also found that City Management has fully remediated 9 items, but needs to take further action on 5 items.

SDCERS Internal Control Remediation

Audit Results (continued)

Status of SDCERS Related Control Weaknesses			
Description of Testing Results	**Under Purview of SDCERS**	**Under Purview of City Management**	**Total**
Number of items fully remediated	12	9	21
Number of items needing additional action to be taken by management	3	5	8
Number of items that were not implemented, but no additional action is being recommended by City Auditor	1	0	1
Total number of items tested	16	14	30

SDCERS Internal Control Remediation

Audit Recommendations

We made 3 recommendations to be implemented by SDCERS and 3 recommendations to be implemented by City management.

Our 6 recommendations pertain to:

- adding language to SDCERS Board rules and polices to ensure:
  - proper administration of the contract for the performance of its actuarial valuation;
  - vendor disclosure requirements for investment consultants and fund managers are adequate;
- finalizing the “Improper Influence” ordinance;
- filling vacancies on the SDCERS Board and improving the Board selection policies/procedures;
- changing the reported status of 4 Kroll items from “Completed” to “Not to be implemented” in order to more accurately portray their actual status.

Items Needing Further Remediation by SDCERS

Kroll Item 99

Kroll recommendation: “SDCERS should re-bid the contract for the performance of its actuarial valuation every five years and that the actuary not be engaged for more than two five-year terms.”

Audit Results

SDCERS’ contract for actuarial services has not exceeded the Kroll recommended time period; however, the current contract with Cheiron, Inc. has renewal options that are not in compliance with the Kroll recommended time limitation.

Items Needing Further Remediation by SDCERS

Audit Recommendation 1:

To ensure compliance with the Kroll report recommendation, SDCERS should amend its Board policy to include a ten year limitation on continuous service on contracts for actuarial valuation services, and ensure future renewals with Cheiron, Inc are in compliance with this policy.

SDCERS does not agree with this recommendation.

Items Needing Further Remediation by SDCERS

SDCERS Response to Audit Recommendation 1:

SDCERS indicated that the terms under which service providers are retained are solely within the purview of the SDCERS Board. Their current Board rules permit contracts to have a term of three years, with two optional one-year extensions, **unless the party hiring the provider determines otherwise.** They also indicated that they have plans to amend their policy to require a re-bid for Cheiron's services after 5 years.

However, there was no indication that they plan to place a ten year limitation on continuous service on contracts for actuarial valuation services.

Items Needing Further Remediation by SDCERS

Kroll Items 100 and 101

Kroll recommendations (respectively):

"SDCERS should require its investment consultants and fund managers to annually complete a Vendor Disclosure Form that calls for disclosure of all information regarding remuneration paid or received related to funds managed for SDCERS, as well as its business dealings with the SDCERS investment consultants."

"Investment consultants and managers should be advised that a failure or delay in filing the annual disclosure will result in a penalty, including termination of services."

Items Needing Further Remediation by SDCERS

Audit Results

- While SDCERS receives disclosure information from its Investment Consultant on a quarterly basis, the fund managers are not requested to provide this disclosure on an ongoing basis.
- SDCERS' Investment Policy Statement, which governs the selection and hiring of asset managers, does not specifically require a disclosure of remuneration paid or received related to funds managed for SDCERS on an annual basis.
- Although SDCERS' Investment Policy allows SDCERS to terminate services with investment managers for operational factors, it is not clear if the investment consultants and fund managers are advised of this stipulation.

Items Needing Further Remediation by SDCERS

Audit Recommendation 2:

SDCERS should modify their Investment Policy Statement to provide a requirement for all contracts with investment consultants and fund managers to include a clause requiring an annual written disclosure of all financial and personal relationships that may give rise to an actual or perceived conflict of interest, and any failure or delay in filing the annual disclosure will result in a penalty, including termination of services.

SDCERS has agreed to modify their Investment Policy Statement to include a contractual provision requiring providers to submit an annual written certification of their compliance with SDCERS' Conflict of Interest Policy.

Items Needing Further Remediation by SDCERS

Kroll Item 120.1

Kroll recommendation: “The annual SDCERS CAFR should include a report from each of its standing committees on significant activities during the year.”

Audit Results

Reports from SDCERS standing committees have not been included in the SDCERS CAFR. However, this recommendation is not a requirement per the Governmental Accounting Standards Board, and we noted that information pertaining to significant activities during the year is included in other sections of the SDCERS CAFR. Therefore, we made no recommendations for additional remediation.

Items Needing Further Remediation by SDCERS

Audit Recommendation 3:

SDCERS should notify City management that they do not intend to include in their CAFR a report from each of its standing committees on significant activities during the year, and that the remediation status of this item should be changed from “Complete” to “Not to be implemented”.

SDCERS agrees with this recommendation.

However, City Management stated that they expect that the intent of the Kroll recommendation will be fully implemented by SDCERS disclosing significant committee activities in the SDCERS CAFR.

Items Needing Further Remediation by City Management

Kroll Item 42

Kroll recommendation: "To discourage any improper influence of the professionals who serve as "gatekeepers" to the public financial reporting process of the City, the Municipal Code should be amended to add criminal penalties for such conduct…"

Items Needing Further Remediation by City Management

Audit Results

Remediation for Kroll item 42 has not yet been completed. The City Attorney has drafted an “Improper Influence” ordinance, but it has not been passed/adopted by the City Council because of outstanding issues that need to be resolved. Some of the outstanding issues are determining what entity should enforce the ordinance, the type of enforcement, and the definition of certain terms.

Items Needing Further Remediation by City Management

Audit Recommendation 4:

The Mayor's Office should take appropriate actions to resolve the outstanding issues with the draft "Improper Influence" ordinance so that the City Council can pass/adopt the ordinance. Additionally, until such time as the ordinance is adopted by City Council, the status of this item should be amended from "Complete or Substantially Complete" to "In Process."

City Management agrees with this recommendation. The City is working on proposal language and will present a revised ordinance to City Council by the end of calendar year 2008.

Items Needing Further Remediation by City Management

Kroll Items 115, 116, 117

Kroll recommendations (respectively):

"The Board of Administration of SDCERS should consist of nine members, including five members (with qualifications otherwise specified in the Charter) who shall be appointed by the Mayor and confirmed by the City Council."

"Two of the four remaining positions shall be elected from police safety members, fire safety members, or general members of the retirement system, in accordance with Charter Section 114(d)."

"The last two remaining positions shall be retired members, of the retirement system and selected in accordance with Charter Section 114(e)."

Items Needing Further Remediation by City Management

Audit Results

Kroll items 115 - 117 have not been implemented. SDCERS' Board currently has 12 members and 2 of these members are continuing to serve after their term limits. The vacant position, as well as the positions held by the 2 members who are serving after their term limits have expired, are Mayoral appointee positions.

We noted that in November 2004, the citizens of San Diego approved Proposition H which changed the composition of the SDCERS' Board to 12 members.

Items Needing Further Remediation by City Management

Audit Results (Kroll Items 115 - 117 continued)

We contacted the City's Independent Monitor, Stanley Keller, requesting his opinion on the current SDCERS Board composition and whether it was appropriate to retain the current composition, as opposed to fully implementing these 3 Kroll recommendations. Per Mr. Keller, the decision to not implement these items is acceptable presuming that steps are taken to appoint 3 new qualified independent members.

Items Needing Further Remediation by City Management

Audit Recommendation 5:

The Mayor's Office should take the steps necessary to fill all SDCERS Board vacancies as soon as possible. Additionally, the status of Kroll items 115, 116 and 117 should be changed from "Complete" to "Not to be implemented."

City Management agrees with this recommendation. The City is currently working to fill the single board vacancy that now exists and two reappointments are under consideration.

Items Needing Further Remediation by City Management

Kroll Item 118.1

Kroll recommendation: “SDCERS board applications should be shared with the Business and Governance Committee of the SDCERS board.”

Audit Results

Currently, there is no written policy requiring the City to share SDCERS board applications with the Business and Governance Committee.

Items Needing Further Remediation by City Management

Audit Recommendation 6:

The Office of Appointments to Boards and Commissions should incorporate into their Board selection policies/procedures language requiring that all applications for final candidates to serve on the SDCERS Board be forwarded to the SDCERS Business and Governance Committee.

City Management agrees with this recommendation. The City has establish a policy and procedure for the SDCERS Board appointments whereby applications will be sent to SDCERS.

Conclusion

Questions or comments?

City of San Diego

AUDIT REPORT

AUDIT OF INTERNAL CONTROL REMEDIATION RELATED TO THE SAN DIEGO CITY EMPLOYEES RETIREMENT SYSTEM

August 29, 2008

Office of the City Auditor
Eduardo Luna, CIA, CGFM, City Auditor

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THE CITY OF SAN DIEGO

DATE: August 29, 2008

TO: Jay M. Goldstone, Chief Operating Officer
David B. Wescoe, SDCERS Administrator / Chief Executive Officer

FROM: Eduardo Luna, City Auditor

SUBJECT: **Audit of Internal Control Remediation Related to SDCERS**

Attached is our audit report with the results of our testing of remediation efforts to correct control weaknesses pertaining to the San Diego City Employees Retirement System (SDCERS) that were identified in the Kroll and KPMG audit reports. The City's and SDCERS' responses to our audit report are attached after page 26. City Auditor staff members that participated in the preparation of this report are Kyle Elser and Tricia Mendenhall.

We would like to thank the City and SDCERS staff for the assistance they extended during our review. All of their valuable time and efforts spent on providing us information is greatly appreciated.

cc: Honorable Mayor Jerry Sanders
Honorable City Councilmembers
Mary Lewis, Chief Financial Officer
Greg Levin, City Comptroller
Mark Hovey, SDCERS Chief Financial Officer
Bob Wilson, SDCERS Internal Auditor
Michael Aguirre, City Attorney
Andrea Tevlin, Independent Budget Analyst
Stan Keller, SEC Consultant

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DIVERSITY BRINGS US ALL TOGETHER THE CITY OF SAN DIEGO

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AUDIT REPORT

Introduction

In accordance with the Fiscal Year 2008 and 2009 Audit Work Plans, the Office of the City Auditor is reviewing management's actions taken to remediate the internal control weaknesses identified by the Kroll Report, internal control letters from the independent auditors, and prior City Auditor and Comptroller reports. As we identify items needing further remediation, we issue an audit report. The subject of this report is the results of our audit testing of remediation efforts to correct the control weaknesses pertaining to the San Diego City Employees Retirement System (SDCERS). These SDCERS related control weaknesses, the remedial actions taken by management, and the audit testing we performed are outlined in detail in Attachment 1. Our work was limited to those specific areas specified in the Objectives, Scope, and Methodology section of this report.

Executive Summary

We have tested the 29 remedial recommendations from the August 8, 2006 Kroll Report and the 1 recommendation made by KPMG in their March 12, 2007 Independent Auditor's Report that relate directly to SDCERS. Of the 30 recommendations (items) tested, 16 items are the responsibility of SDCERS to implement and the remaining 14 items are the responsibility of City management to implement.

Based on our testing of 30 SDCERS related items that have been reported as remediated by management, we determined that 21 of the items have been fully remediated, 8 items need additional action to taken by management, and 1 item was not implemented as recommended by Kroll; however, we agree that it is not necessary

for this recommendation to be implemented. A summary of our audit testing is shown in Table A.

TABLE A – SUMMARY OF AUDIT TESTING

Description of Testing Results	STATUS OF SDCERS Related Control Weaknesses		
	Under Purview of SDCERS	Under Purview of City Management	Total
Number of items fully remediated	12	9	21
Number of items needing additional action to be taken by management	3	5	8
Number of Items that were not implemented, but no additional action is being recommended by City Auditor	1	0	1
Total number of items tested	16	14	30

We have made 3 recommendations to be implemented by SDCERS and 3 recommendations to be implemented by City management. Our 6 recommendations pertain to:

- adding language to SDCERS Board rules and polices to ensure:
    - proper administration of the contract for the performance of its actuarial valuation;
    - vendor disclosure requirements for investment consultants and fund managers are adequate;
- finalizing the “Improper Influence” ordinance;
- filling vacancies on the SDCERS Board and improving the Board selection policies/procedures;
- changing the reported status of 4 Kroll items from “Completed” to “Not to be implemented” in order to more accurately portray their actual status.

Background

On August 8, 2006, The Audit Committee of the City of San Diego (Kroll), issued a report entitled “Investigation Into the San Diego City Employees’ Retirement System and The City of San Diego Sewer Rate Structure”, more commonly referred to as “the Kroll Report”. On August 24, 2006, the Mayor issued a memo to City Council responding to the remedial recommendations outlined in the Kroll Report. This memo details over 120 remedial recommendations that were offered by the Audit Committee.

Subsequent to the issuance of the Kroll Report, additional recommendations to improve internal controls have been made by independent auditors during the course of auditing the City of San Diego’s Financial Statements, as well as by the Auditor and Comptroller during the review of internal controls over financial reporting.

In total, the Kroll report outlined 29 remedial recommendations to be implemented by the City of San Diego pertaining to SDCERS. In its March 12, 2007 “Independent Auditors’ Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Standards”, KPMG noted 1 additional recommendation related to SDCERS. Of the 30 total recommendations, 16 fall under the purview of SDCERS, and 14 fall under the purview of the City as shown in Attachment 1.

In the Mayor’s January 28, 2008 Kroll Remediation Status Report Number 6, the 29 recommendations were all reported as “Completed or Substantially Completed” and the recommendation by KPMG was reported as “remediated” in the Comptroller’s January 28, 2008 presentation to the Audit Committee regarding the Internal Controls Over Financial Reporting Project (ICOFR).

Audit Objective, Scope, and Methodology

The objective of this audit is to evaluate the remediation efforts of management to correct all known internal control weaknesses that have been identified in the Kroll Report, internal control letters from the independent auditors (KPMG LLP and Macias Gini & O'Connell LLP), and the prior Auditor and Comptroller's Internal Control Reports. When internal control weaknesses are reported by the Comptroller's Internal Control Manager as "Completed" or "Remediated", testing by the City Auditor can begin. As we identify items needing further remediation, we issue an audit report.

The scope of this report is the Audit testing results of the 30 internal control weaknesses related specifically to SDCERS.

The following audit procedures[1] were used to achieve the audit objective:

- Reviewed Agendas and Minutes to various SDCERS' Board and City Council Meetings.
- Reviewed controlling legal documents, specifically; various articles of the San Diego City Charter, the San Diego Municipal Code, the Rules of the Retirement Board of Administration and various contracts between SDCERS and consultants.
- Met with various City staff and SDCERS' CFO and Internal Auditor to discuss the remediation efforts for the control weaknesses related to SDCERS.
- Where applicable, contacted the Independent Consultant, Stanley Keller, for opinion on various items.
- Reviewed various SDCERS' staff written procedures.
- Reviewed the City of San Diego and SDCERS' FY 2003, 2004 and 2005 CAFRs.
- Reviewed the FY 2006, 2007 and 2008 SDCERS' Actuarial Valuations produced by Cheiron.
- Reviewed the Expert Report of Joseph Esuchanko, dated March 19, 2007.

[1] Specific documentation reviewed during testing of each recommendation can be seen on Attachment 1.

- Reviewed the Pension Reform Committee's Final Report, dated September 15, 2004.
- Reviewed the San Diego Charter Review Committee's Final Report, dated October 4, 2007.
- Reviewed the City of San Diego Five Year Financial Outlook, Fiscal Years 2008 - 2012, dated November 29, 2006.

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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

We evaluated specific internal controls related to the audit objectives. Our review focused on the control weaknesses previously identified by the Kroll and independent auditors' reports related to SDCERS and the remediation of those control weaknesses. We did not perform in depth testing of the overall effectiveness of the internal controls related to SDCERS' activities. Our conclusions on the effectiveness of the controls implemented to correct previously identified weaknesses related to SDCERS are detailed in this audit report.

Audit Results

We tested 30 recommendations (items) reported as "remediated" or "completed" to verify that the actions taken by SDCERS' and City management have been implemented. Of the 30 items tested, 16 items are the responsibility of SDCERS to implement and the remaining 14 items are the responsibility of City Management to implement.

We found that SDCERS has fully remediated 12 items as recommended and needs to take further actions on 3 items. We also found that 1 item was not implemented, but we are not offering a recommendation for further action. We also found that City Management has fully remediated 9 items, but needs to take further action on 5 items.

A detailed analysis of our audit conclusions and recommendations for full implementation of the remaining Kroll and/or KPMG recommendations related to SDCERS follows.

Items under SDCERS Purview Requiring Additional Remediation Efforts

Kroll Item 99

Kroll recommendation number 99 states that "SDCERS should re-bid the contract for the performance of its actuarial valuation every five years and that the actuary not be engaged for more than two five-year terms".

The implementation of this recommendation signifies the importance of the City's annual required contribution (ARC), as calculated by an actuary. A portion of the City's ARC goes to pay down the unfunded actuarial accrued liability (UAAL) over time.

A review of SDCERS' policy for selecting and hiring Actuaries, specifically pertaining to contract terms, is in compliance with the Kroll recommendation; however additional actions are needed to ensure future compliance. SDCERS' policy establishes that service provider contracts executed after February 21, 2003, shall have a term of three years, with two optional one-year extensions, unless the party hiring the provider determines otherwise. However, the current contract between Cheiron, Inc (SDCERS' current actuary) and SDCERS, dated June 14, 2006, establishes the term of the agreement for the valuation of 3 fiscal years (FY 2005, FY 2006 and FY 2007) with renewal options that are not in compliance with their policy and the Kroll recommendation. The agreement automatically renews for subsequent and successive five year periods under the same terms, etc., unless either party requests changes not

less than 90 days prior to June 30 of the final valuation year of the then current term. If this option is taken, the contract will exceed the 10 year limit as recommended by Kroll. It should be noted that the Cheiron contract does have a provision for SDCERS to terminate the contract upon 10 day notice with or without cause.

Recommendation:

1. To ensure compliance with the Kroll report recommendation, SDCERS should amend its Board policy to include a ten year limitation on continuous service on contracts for actuarial valuation services, and ensure future renewals with Cheiron, Inc are in compliance with this policy.

Kroll Item 100 and 101

Kroll recommendation numbers 100 and 101 state, respectively:

> "SDCERS should require its investment consultants and fund managers to annually complete a Vendor Disclosure Form that calls for disclosure of all information regarding remuneration paid or received related to funds managed for SDCERS, as well as its business dealings with the SDCERS investment consultants".
>
> "Investment consultants and managers should be advised that a failure or delay in filing the annual disclosure will result in a penalty, including termination of services".

SDCERS' Board should receive full disclosure of investment consultants and fund manager's financial dealings with managers that they recommend. This information is required in order for the Board to competently evaluate the advice it receives from investment consultants and fund managers, as part of its fiduciary responsibility to safeguard the system's assets.

These items have not been fully remediated. While SDCERS receives disclosure information from its Investment Consultant on a quarterly basis, the fund managers are not requested to provide this disclosure on an ongoing basis. Additionally, SDCERS' Investment Policy Statement, which governs the selection and hiring of asset managers, does not specifically require a disclosure of remuneration paid or received related to funds managed for SDCERS on an annual basis. However, SDCERS advised that all future contracts will include a requirement for all vendors to disclose in writing all financial and personal relationships that may give rise to an actual or perceived conflict of interest.

In addition, although SDCERS' Investment Policy allows SDCERS to terminate services with investment managers for operational factors, it is not clear if the investment consultants and fund managers are advised of this stipulation.

Recommendation:

2. SDCERS should modify their Investment Policy Statement to provide a requirement for all contracts with investment consultants and fund managers to include a clause requiring an annual written disclosure of all financial and personal relationships that may give rise to an actual or perceived conflict of interest and any failure or delay in filing the annual disclosure will result in a penalty, including termination of services.

Kroll Item 120.1

Kroll recommendation number 120.1 states "The annual SDCERS' CAFR should include a report from each of its standing committees on significant activities during the year".

Reports from SDCERS' standing committees have not been included in the SDCERS' CAFR. However, this recommendation is not a requirement per the Governmental Accounting Standards Board, and we noted that information pertaining to significant activities during the year is included in other sections of the SDCERS' CAFR. In

addition, we contacted Stanley Keller, the City's Independent Consultant, requesting his opinion on the inclusion of standing committee reports in the CAFR. Per Mr. Keller, the issue is the overall quality and approach of SDCERS' governance, including its committee structure and functioning and that this particular recommendation standing alone is not consequential. It should be noted that the SDCERS' committee structure and functioning are part of Kroll Item 120, which audit testing concluded as successfully remediated (see Attachment 1, page 18).

Therefore, we made no additional recommendations pertaining to the remediation of this item. However, we are recommending that the reported remedial status be changed.

Recommendation:

3. SDCERS should notify City management that they do not intend to include in their CAFR a report from each of its standing committees on significant activities during the year, and that the remediation status of this item should be changed from "Complete" to "Not to be implemented".

Items under the City of San Diego Purview Requiring Additional Remediation Efforts

Kroll Item 42

Kroll recommendation number 42 states that "To discourage any improper influence of the professionals who serve as "gatekeepers" to the public financial reporting process of the City, the Municipal Code should be amended to add criminal penalties for such conduct. It should be unlawful for any elected official, or employee of the City, or anyone acting under their direction, to take any action to corruptly influence, coerce, manipulate or mislead any independent certified public accountant engaged in the performance of an audit of the financial statements of the City or its component units, or outside legal counsel performing services for the City in connection with an offering statement of the City, or any actuary performing services for the City in connection with

an offering statement of the City, or any actuary performing an actuarial valuation in connection with the preparation of the City's or SDCERS' CAFRs, or employees of a bond rating agency performing a credit rating of the City's bonds."

Remediation for Kroll item 42 has not been completed. The City Attorney has drafted an "Improper Influence" ordinance, but it has not been passed/adopted by the City Council because of outstanding issues that need to be resolved. Some of the outstanding issues are determining what entity should enforce the ordinance, the type of enforcement, and the definition of certain terms.

Recommendation:

4. The Mayor's Office should take appropriate actions to resolve the outstanding issues with the draft "Improper Influence" ordinance so that the City Council can pass/adopt the ordinance. Additionally, until such time as the ordinance is adopted by City Council, the status of this item should be amended from "Complete or Substantially Complete" to "In Process".

<u>Kroll Items 115, 116, 117</u>

Kroll recommendation numbers 115 to 117 state, respectively:

> "The Board of Administration of SDCERS should consist of nine members, including five members (with qualifications otherwise specified in the Charter) who shall be appointed by the Mayor and confirmed by the City Council."
>
> "Two of the four remaining positions shall be elected from police safety members, fire safety members, or general members of the retirement system, in accordance with Charter Section 114(d)."
>
> "The last two remaining positions shall be retired members, of the retirement system and selected in accordance with Charter Section 114(e)."

These recommendations have not been implemented. SDCERS' Board currently has 12 members and 2 of these members are continuing to serve after their term limits. The vacant position, as well as the positions held by the 2 members who are serving after their term limits have expired, are Mayoral appointee positions.

However, in November 2004, the citizens of San Diego approved Proposition H which changed the composition of the SDCERS' Board as follows: 7 highly qualified citizen appointees without interests in the City's pension system, 4 members elected from classifications of active membership (1 police, 1 fire, 2 general), 1 member elected from the ranks of the retired, and 1 member appointed by the City Manager (Mayor). Additionally, the San Diego Charter Review Committee's Final Report dated October 4, 2008 recommended to retain the status quo in regard to the SDCERS' Board composition as previously modified by Proposition H.

Kroll believed a nine-member Board would be "small enough to encourage collaboration and collegial exchange of views, yet sufficient to oversee the Retirement Plan and the work performed by the approximately 60 employees of SDCERS"[1].

We contacted Stanley Keller requesting his opinion on the current SDCERS' Board composition and whether it was appropriate to retain the current composition, as opposed to fully implementing these 3 Kroll recommendations. Per Mr. Keller, the decision to not implement these items is acceptable presuming that steps are taken to appoint 3 new qualified independent members.

Recommendation:

5. The Mayor's Office should take the steps necessary to fill all SDCERS' Board vacancies as soon as possible. Additionally, the status of Kroll items 115, 116 and 117 should be changed from "Complete" to "Not to be implemented".

[1] Report of the Audit Committee of the City of San Diego (Kroll Report), page 256.

Kroll Item 118.1

Kroll recommendation number 118.1 states that "SDCERS board applications should be shared with the Business and Governance Committee of the SDCERS board".

The process of identifying and evaluating prospective SDCERS' Board members should be undertaken with great care. Providing board applications to the SDCERS' Board for those applicants who are ultimately appointed to the Board, will assist in providing relevant information with respect to possible conflicts of interest during Board actions.

Currently, there is no written policy requiring the City to share SDCERS' board applications with the Business and Governance Committee of the SDCERS' board.

Recommendation:

6. The Office of Appointments to Boards and Commissions should incorporate into their Board selection policies/procedures language requiring that all applications for final candidates to serve on the SDCERS' Board be forwarded to the SDCERS Business and Governance Committee.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
SDCERS Purview				
1	97	The Audit Committee concurs with actions being taken by the Retirement Administrator to establish a financial reporting function within SDCERS.	Per SDCERS' letter to Jay Goldstone dated 1/31/07: "SDCERS' Financial Reporting and Administration Division…has been expanded to include four accountants, one management analyst and three support staff - the most experienced and talented financial team in SDCERS' history."	Based on a review of the following documents, audit concluded this item as successfully remediated: • SDCERS' org chart, as posted on 1/10/08 on the SDCERS' website. The org chart shows a Finance and Administration Division led by a CFO, who reports to the CEO/Retirement Administrator. • Resumes of 2 accountants employed by SDCERS. Both accountants each had a minimum of 19 years experience with the City's financial operations.
2	98	SDCERS should develop a comprehensive methodology to identify, track, and recover overpayments made to deceased pensioners.	Per SDCERS' letter to Jay Goldstone dated 1/31/07: "In January 2005, SDCERS' Benefits Administration Division implemented a comprehensive review of deceased Member and Beneficiary accounts. This review includes identifying, tracking and recovering overpayments made to deceased Members and Beneficiaries. In September 2006, SDCERS improved this process by implementing monthly social security number "death matches." As a result, outstanding overpayments have all but been eliminated."	Based on a review of the following documents, audit concluded this item as successfully remediated: • A summary of the deceased member review completed by SDCERS' staff in January 2005. • Various written procedures for SDCERS' staff to follow upon the notification of a member's death, including steps to pro-rate payments, recover overpayments, and a checklist to guide staff through the steps. • Copies of invoices paid to private vendor or monthly social security "death match" reviews and subsequent reports provided to SDCERS by the private vendor resulting from the monthly reviews.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
3	99	SDCERS should re-bid the contract for the performance of its actuarial valuation every five years and that the actuary not be engaged for more than two five-year terms.	Per SDCERS' letter to Jay Goldstone dated 1/31/07: "In 2005, SDCERS contracted with Cheiron for valuation years ending June 30, 2005 through June 30, 2007. While the contract provides for a five-year automatic extension, it may be terminated by SDCERS without cause at any time."	Audit concluded this item as successfully remediated with an additional recommendation. See recommendation number 1 on page 7 of the report.
4	100	SDCERS should require its investment consultants and fund managers to annually complete a Vendor Disclosure Form that calls for disclosure of all information regarding remuneration paid or received related to funds managed for SDCERS, as well as its business dealings with the SDCERS investment consultants.	Per SDCERS' letter to Jay Goldstone dated 1/31/07: "SDCERS' investment consultant discloses any relationship where they receive remuneration from investment managers. In addition, SDCERS requires disclosure from its investment managers of any soft dollar arrangements involving SDCERS' assets." Additionally, per a memo provided to Kyle Elser, Audit Manager on 1/23/08, from Bob Wilson, SDCERS Internal Auditor, "Our investment managers' contract language has not been amended to require disclosure of information concerning what services a manager may be purchasing from our Investment Consultant. Rather, we have requested that the consultant, Callan Associates, disclose in their quarterly reports to SDCERS the investment firms that it receives compensation from for various services. Callan has been making this disclosure on a regular basis since the quarter ending December 2004."	Audit concluded this item has not been fully remediated. See recommendation number 2 on page 8 of the report.
5	101	Investment consultants and managers should be advised that a failure or delay in filing the annual disclosure will result in a penalty, including termination of services.	Per SDCERS' letter to Jay Goldstone dated 1/31/07: "Failure by any firm to disclose the information outlined in response to item 100 can result in penalties up to and including termination of their contract with SDCERS."	Audit concluded this item has not been fully remediated. See recommendation number 2 on page 8 of the report.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
6	102	The Retirement Administrator and CFO of SDCERS should annually include in the SDCERS' CAFR a signed management report on the financial statements and disclosures which include a statement of SDCERS' responsibility for establishing and maintaining an effective system of internal control over financial reporting and disclosures; a statement setting forth SDCERS' assessment of the effectiveness of the internal controls; a statement that based on their knowledge, the CAFR does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the CAFR not misleading; and a statement that the financial statement and other information included in the CAFR fairly present in all material respects the net assets and activities of SDCERS for the period presented.	Per SDCERS' 12/17/07 response to Audit re: remediation status: "SDCERS is committed to accepting responsibility for establishing and maintaining an effective system of internal control over financial reporting and disclosures. As such, SDCERS plans to comply with the 2005 edition (most current) of the Government Finance Officers Association (GFOA) "Blue Book," Governmental Accounting, Auditing, and Financial Reporting (GAAFR) that provides guidance on financial reporting for state governments. The GAAFR's latest guidance on transmittal letters is that they contain a statement that says "Management assumes full responsibility for the completeness and reliability of the information contained in this report, based upon a comprehensive framework of internal control that it has established for this purpose. Because the cost of internal control should not exceed anticipated benefits, the objective is to provide reasonable, rather than absolute, assurance that the financial statements are free of any material misstatements." The GAAFR's guidance is consistent with GASB Statement No. 34, Basic Financial Statements, and Management's Discussion and Analysis for State and Local Governments. SDCERS will include this statement in its CAFR transmittal letter consistent with this guidance beginning with the June 30, 2006 report. The City adopted similar language in its 2005 CAFR Transmittal Letter, and Macias Gini & O'Connell also concur with this approach."	Based on a review of the transmittal letter included in the SDCERS FY06 CAFR, audit concluded this item as successfully remediated.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
7	104	For purpose of calculating annual funding requirements, the UAAL should reflect a prudent view of economic reality and include within it the costs of the Corbett settlement.	Per the 4/9/07 5th Mayor Kroll Status report: "Substantially complete. SDCERS Board action approved and directed the actuary to include the costs of the Corbett settlement and 13th check. The Actuary report dated January 2007 contains these components in the UAAL. The Actuarial Valuation Report was presented at the SDCERS board meeting dated January 19, 2007. In addition, the SDCERS Board has directed its actuary to complete an experience study which will be presented to the Board in the winter of 2008. This study will provide the Board with information to make further assumption decisions such as the appropriate discount rate and salary growth SDCERS should use."	Based on a review of the following documents, audit concluded this item as successfully remediated: • SDCERS' June 30, 2006 Actuarial Valuation produced by Cheiron. • SDCERS' June 30, 2005 Actuarial Valuation produced by Cheiron. • Expert Report of Joseph Esuchanko, dated March 19, 2007
8	107	The City and SDCERS should make a voluntary disclosure through a self-reporting process to the IRS of the amount of any improper diversion of funds used to pay retiree health care benefits and cooperate with the IRS to bring the City's retiree healthcare funding into full compliance.	Per the 11/22/06 3rd Mayor Kroll Status report: "Complete. SDCERS tax consultant, Ice Miller LLP, filed a Voluntary Correction Plan report titled "Exclusive Benefit and Prohibited Transactions – Retiree Medical Benefits (401(h) Account)" with the Internal Revenue Service on June 22, 2006."	Based on a review of Voluntary Correction Plan report filed by SDCERS' tax consultant with the IRS on 6/22/06, audit concluded this item as successfully remediated.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
9	110	The plan's actuary should be engaged to develop a responsible funding program that considers expected cash distributions and the obligations to new and existing plan members. Note – "It is recommended that the City use the same period for amortization of both gains and losses." This statement is ambiguous; the City does not amortize gains and losses. However, SDCERS financial statements are included in the City's CAFR, and therefore, the City would be "using the same period for amortization of both gains and losses" as those used by SDCERS.	Per the 4/9/07 5th Mayor Kroll Status report: "Complete. At its March 16, 2007 Board meeting, SDCERS adopted a 20 year amortization schedule to pay off the current UAAL. As part of the motion, the actuary was instructed to ensure that his calculation did not include any negative amortization. In addition, the SDCERS Board adopted a 15 year amortization schedule for all future gains or losses and a five year amortization schedule for any new pension benefits approved by the City. This will take affect for the June 30, 2007 actuarial valuation which will be reflected in the City's fiscal year 2009 budget." The Mayor has included a supplemental pension payment in his proposed fiscal year 2008 budget to ensure no negative amortization and the beginning payoff of the existing UAAL.	Based on a review of the following documents, audit concluded this item as successfully remediated: • SDCERS' June 30, 2007 Actuarial Valuation produced by Cheiron. • Expert Report of Joseph Esuchanko, dated March 19, 2007
10	112	To address Board authority and pursue administrative excellence, the controlling documents should be reviewed and, if necessary, modified to ensure that the Board has the necessary tools available to effectively and efficiently carry out its fiduciary duties.	Per SDCERS' letter to Jay Goldstone dated 1/31/07: "Over the next several months, SDCERS' Business and Governance Committee, together with our General Counsel and Chief Compliance Officer, will review all existing SDCERS' policies and applicable City ordinances to ensure that all SDCERS' policies and City laws reflect best practices in the public pension area." Per SDCERS' letter to Jay Goldstone dated 8/17/07, "SDCERS is reviewing and amending, where necessary, its controlling documents."	Based on a review of the following documents, audit concluded this item as successfully remediated: • SDCERS' controlling legal documents, specifically the San Diego City Charter (Articles IX and X), the San Diego Municipal Code, and the Rules of the Retirement Board of Administration. • The Navigant Report Committee's Final Report, dated 11/3/06.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
11	113	The controlling legal documents must make the Board's authority clear related to investment policy, actuarial assumptions, system budget and policies, retention of outside professionals, and administrative rules.	Per SDCERS' letter to Jay Goldstone dated 1/31/07: "They do."	Based on a review of the following documents, audit concluded this item as successfully remediated: • SDCERS' controlling legal documents, specifically the San Diego City Charter (Articles IX and X), the San Diego Municipal Code, and the Rules of the Retirement Board of Administration.
12	114	The chief accounting officer of SDCERS should have adequate prior experience with investment operations and financial reporting and disclosures.	Per SDCERS' letter to Jay Goldstone dated 1/31/07: "As discussed in item 97 above, effective on July 10, 2006, the CFO position was elevated to report directly to SDCERS' CEO. The current CFO, Bob Wilson, has a BS in accounting….."	Based on a review of the following documents, audit concluded this item as successfully remediated: • SDCERS' organization chart showing a CFO. • Copy of current CFO's resume.
13	119	SDCERS should have standing committees to address board governance, compensation and evaluation of the Retirement Administrator, investments, and an audit and compliance committee.	Per SDCERS' letter to Jay Goldstone dated 1/31/07: "SDCERS' standing committees include Investments, Business and Governance, Executive, Audit and Disability. "	Based on a review of the following documents, audit concluded this item as successfully remediated: • SDCERS' Board rules pertaining to Committees. • Various Committees meeting agendas and meeting minute summaries via SDCERS' webpage.
14	120	SDCERS should adopt a formal charter for each committee which should be updated no less frequent than every three years.	Per SDCERS' letter to Jay Goldstone dated 8/17/07: "Division 3 of SDCERS' Board Rules establishes the composition of the Board Committees and delineates their responsibilities. Division 3 was amended by the Board in June and September 2006 to establish the composition of each committee and to update each committee's scope of responsibilities. These Board Rules are "charters" for our Board Committees and adequately describe the responsibilities of its committees."	Based on a review of the SDCERS' Board Rules and results of 7/18/08 SDCERS' Board meeting, audit concluded this item as successfully remediated.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
15	120.1	The annual SDCERS CAFR should include a report from each of its standing committees on significant activities during the year.	Per SDCERS' 12/17/07 response to Audit re: remediation status: "SDCERS will not include separate reports from its standing committees in its annual CAFR. Reports of this type are neither required nor suggested by the Governmental Accounting Standards Board in its required presentations for pension fund financial statements. To SDCERS' knowledge, no other California public pension fund includes such reports in their CAFRs. SDCERS' CAFRs do include transmittal letters from the CEO and Board President, disclosure Notes to the Financial Statements, and complete and comprehensive Investment and Actuarial Sections."	Audit concluded this item has not been remediated. However, this recommendation is not a requirement per the Governmental Accounting Standards Board. In addition, information pertaining to significant activities during the year is included in other sections of the SDCERS' CAFR. Therefore, audit has made no additional recommendations pertaining to remediation of this item, but rather a recommendation pertaining to its remedial status. See recommendation number 3 on page 9 of the report.
16	121	SDCERS must be free to retain its own independent legal counsel.	Per SDCERS' letter to Jay Goldstone dated 1/31/07: "It is. SDCERS vigorously asserted its right to retain its own independent counsel in litigation with the City Attorney of San Diego and prevailed. On November 6, 2006, SDCERS hired Christopher W. Waddell, formerly General Counsel of CalSTRS, as its new General Counsel."	Based on a review of the following documents, audit concluded this item as successfully remediated: • Staff Report to the SDCERS' Board, dated 3/7/06, discussing the court case filed by the SDCERS' Board against the City and the City Attorney seeking judicial declaration that SDCERS is entitled to retain its own legal counsel. • The Order After Hearing Minutes pertaining to the court case and the judge's ruling that SDCERS is empowered to employ legal counsel of its own choosing.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
City of San Diego Purview				
1	42	To discourage any improper influence of the professionals who serve as "gatekeepers" to the public financial reporting process of the City, the Municipal Code should be amended to add criminal penalties for such conduct. It should be unlawful for any elected official, or employee of the City, or anyone acting under their direction, to take any action to corruptly influence, coerce, manipulate or mislead any independent certified public accountant engaged in the performance of an audit of the financial statements of the City or its component units, or outside legal counsel performing services for the City in connection with an offering statement of the City, or any actuary performing an actuarial valuation in connection with the preparation of the City's or SDCERS's CAFRs, or employees of a bond rating agency performing a credit rating of the City's bonds.	Per the 11/22/06 3rd Mayor Kroll Status report: "City Attorney action complete. The City Attorney prepared an ordinance and submitted it for City Council Action on November 1, 2006. On November 13, 2006, at the Special City Council Financial Hearing, the ordinance was referred to the Rules Committee. The Rules Committee is tentatively scheduled to review the ordinance at its scheduled meeting on January 10, 2007."	Audit concluded this item has not been fully remediated. See recommendation number 4 on page 10 of the report.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
2	103	The City should contribute to SDCERS annually the Annual Required Contribution, as calculated by SDCERS actuary, including an amount sufficient to amortize existing UAAL over a reasonable period of time that assures that current taxpayers are paying for the full cost of services rendered by employees of the City and not passed on to future generations.	Per the 2/21/07 4th Mayor Kroll Status report: "Complete. The Mayor's Five Year Plan contains full ARC (Annual Required Contribution) contributions over an amortization period in compliance with the "Gleason Settlement." The City's budget for fiscal year 2007 contains a contribution of $162 million to pay the full ARC. This contribution was made at the beginning of the fiscal year (July 2006). Additionally, the plan for fiscal years 2008-2012 provides for payment of ARC plus to eliminate negative amortization of the UAAL (Unfunded Actuarial Accrued Liability). The ARC plus contribution amounts to an additional $27.1 million annual contribution over this period, or $135.5 million in total. The survey results can be accessed on the City's website at: http://www.sandiego.gov/mayor/pdf/five_year_plan_11_15.pdf"	Based on a review of the following documents, audit concluded this item as successfully remediated: • City of San Diego Five Year Plan. • SDCERS' Cash Transaction Statement Reports for July 2006 and July 2007 detailing deposits of the ARC payment by the City to SDCERS. *Note: Testing of this item was included in the January 1, 2008 Annual Report on Internal Controls – Exhibit D, item 1.*
3	105	The City should not be relieved of the obligation to make annual ARC payments because the system's funded ratio has grown to a level deemed more acceptable, such as the 82.3% MP-1 trigger.	Per the 1/28/08 6th Mayor Kroll Status report: "Completed. The City's funding strategy and five year financial outlook do not relieve the City of its obligation to make ARC (Annual Required Contribution) payments if the system's funded ratio exceeds a certain target. Additionally, the City's FY2008 payment exceeds the ARC provided by SDCERS."	Based on a review of the following documents, audit concluded this item as successfully remediated: • City of San Diego Five Year Plan. • SDCERS' Cash Transaction Statement Reports for July 2006 and July 2007 detailing deposits of the ARC payment by the City to SDCERS.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
4	106	The City should not use its contribution to pay for any benefits other than retirement benefits and the related costs of administering the Plan. Thus, no portion of the City's annual contribution to SDCERS should be credited against the City's obligation to pay retiree healthcare costs, or for any other of the so-called "Waterfall" payments, unless and until the City pays the required ARC.	Per the 1/28/08 6th Mayor Kroll Status report: "An amendment repealing the "Waterfall" was introduced to the City Council on March 5, 2007; it was continued from meetings of April 10, 2007, April 17, 2007, May 1, 2007, and May 14, 2007; it was returned to the City Attorney on June 5, 2007, to bring back the item with alternative language consistent with the Independent Budget Analyst's recommendations."	Based on a review of the following documents, audit concluded this item as successfully remediated: • Mayor's November 29, 2006 Five Year Financial Outlook. • ARC payments made by the City in FY08. • Cheiron June 30, 2006 Actuarial Valuation. • Results of July 21, 2008 City Council Meeting passing the amendments to the San Diego Municipal Code eliminating the surplus undistributed earnings (Waterfall).
5	107.1	Make early disclosure of such costs (retiree healthcare benefits) in its next issued financial statement.	Per the 10/5/06 1st Mayor Kroll Status report: "While the City has not published the Net OPEB Obligation on its balance sheet, it has disclosed its actuarially developed liability in the transmittal letter of the fiscal year 2003 CAFR. It will do the same in all subsequent CAFRs and will begin reporting its Net OPEB Obligation in fiscal year 2008."	Based on a review of the City of San Diego FY03, 04 and 05 CAFRS verifying the disclosure of the actuarially developed liability in the transmittal letter, audit concluded this item as successfully remediated.
6	108	The costs should be reflected in the City's annual budget and five-year plan, and variances caused by changes in actuarial assumptions should be explained. (Costs refer to costs for proposed new retirement benefits for City employees.)	Per the 11/22/06 3rd Mayor Kroll Status report, "The City acknowledges the need to accurately calculate the costs of any new retirement benefits and includes such costs in all budgets and five year plans. Additionally, the voters passed Proposition B which will require the City to obtain voter approval for any increases (with the exception of cost-of-living) in municipal pension benefits."	Based on a review of the following documents, audit concluded this item as successfully remediated: • Article VII, Section 69 of the City Charter pertaining to the budget requirement • SDCERS' Actuarial Valuations performed by Cheiron for fiscal years 2006 and 2007.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
7	109	The City, in response to the Report of the Pension Reform Committee, amended the Charter to require net actuarial losses be amortized over a period not longer than 15 years, net actuarial gains over a period not shorter than five years, and that SDCERS use an amortization period no greater than a fixed, straight-line five years for each new benefit improvement. It is recommended that the City use the same period for amortization of both gains and losses.	Per the 4/9/07 5th Mayor Kroll Status report: "Complete. At its March 16, 2007 Board meeting, SDCERS adopted a 20 year amortization schedule to pay off the current UAAL. As part of the motion, the actuary was instructed to ensure that his calculation did not include any negative amortization. In addition, the SDCERS Board adopted a 15 year amortization schedule for all future gains or losses and a five year amortization schedule for any new pension benefits approved by the City. This will take affect for the June 30, 2007 actuarial valuation which will be reflected in the City's fiscal year 2009 budget. The Mayor has included a supplemental pension payment in his proposed fiscal year 2008 budget to ensure no negative amortization and the beginning payoff of the existing UAAL."	Based on a review of the following documents, audit concluded this item as successfully remediated: • SDCERS' Board meeting summary for 3/16/07 where the Board adopted a 20 year fixed schedule with no negative amortization of the UAAL, a 15 year fixed amortization schedule for future gains and losses related to experience and a 5 year fixed amortization schedule for changes in the UAAL attributable to benefit increases. • Excerpts from the FY08 City of San Diego budget and the FY05 City of San Diego CAFR.
8	111	The Pension Reform Committee assessed the pension plans under funded status and offered recommendations related to reducing or eliminating the City's UAAL and reducing the ongoing annual costs related to the plan and contingent benefits. The City should re-evaluate the Committee's recommendations and, beyond those previously addressed in our Report, consider enacting those that are appropriate that do not conflict with our Remediation Plan.	Per the 4/9/07 5th Mayor Kroll Status report: "Complete. At its March 16, 2007 Board meeting, SDCERS adopted a 20 year amortization schedule to pay off the current UAAL. As part of the motion, the actuary was instructed to ensure that his calculation did not include any negative amortization. In addition, the SDCERS Board adopted a 15 year amortization schedule for all future gains or losses and a five year amortization schedule for any new pension benefits approved by the City. This will take affect for the June 30, 2007 actuarial valuation which will be reflected in the City's fiscal year 2009 budget. The Mayor has included a supplemental pension payment in his proposed fiscal year 2008 budget to ensure no negative amortization and the beginning payoff of the existing UAAL."	Based on a review of the following documents, audit concluded this item as successfully remediated: • Pension Reform Committee Final Report, dated 9/15/04. • Kroll Report, dated 8/8/06 – specifically, pages 83 to 86 pertaining to the Pension Reform Committee's Final Report and the recommendations contained therein.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
9	115	The Board of Administration of SDCERS should consist of nine members, including five members (with qualifications otherwise specified in the Charter) who shall be appointed by the Mayor and confirmed by the City Council.	Per the 1/28/08 6th Mayor Kroll Status report: "Completed. Items 115 through 118.1 are the City of San Diego's responsibility. The Mayor's August 24, 2006 Kroll Report response states that City management agrees with these recommendations; however, they will require a Charter amendment. Ballot language will be developed and ready to be placed on the June 2008 general City election. In November 2004, San Diego voters approved Proposition H, which amended Section 144 of the City Charter. Proposition H maintained thirteen members of the Board, but allocated the seats differently by providing the majority membership to appointees."	Audit concluded this item has not been fully remediated. See recommendation number 5 on page 11 of the report.
10	116	Two of the four remaining positions shall be elected from police safety members, fire safety members, or general members of the retirement system, in accordance with Charter Section 114(d).	Per the 1/28/08 6th Mayor Kroll Status report: "Completed. Items 115 through 118.1 are the City of San Diego's responsibility. The Mayor's August 24, 2006 Kroll Report response states that City management agrees with these recommendations; however, they will require a Charter amendment. Ballot language will be developed and ready to be placed on the June 2008 general City election. In November 2004, San Diego voters approved Proposition H, which amended Section 144 of the City Charter. Proposition H maintained thirteen members of the Board, but allocated the seats differently by providing the majority membership to appointees."	Audit concluded this item has not been fully remediated. See recommendation number 5 on page 11 of the report.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
11	117	The last two remaining positions shall be retired members, of the retirement system and selected in accordance with Charter Section 114(e).	Per the 1/28/08 6th Mayor Kroll Status report: "Completed. Items 115 through 118.1 are the City of San Diego's responsibility. The Mayor's August 24, 2006 Kroll Report response states that City management agrees with these recommendations; however, they will require a Charter amendment. Ballot language will be developed and ready to be placed on the June 2008 general City election. In November 2004, San Diego voters approved Proposition H, which amended Section 144 of the City Charter. Proposition H maintained thirteen members of the Board, but allocated the seats differently by providing the majority membership to appointees."	Audit concluded this item has not been fully remediated. See recommendation number 5 on page 11 of the report.
12	118	Prior to any appointment, each potential appointee be required to complete a written application listing qualifications for the position and any factors that may impact on that decision, and that the applicants be required to affirm the accuracy of the application and a background check of the applicants should be done by the appropriate City department.	Per the 1/28/08 Mayor's 6th Kroll Status update this item is completed (no additional comments related to this item made).	Based on a review of the following documents, audit concluded this item as successfully remediated: • A copy of the application form required to be completed by all boards and commissions appointment applicants. • Overview of the steps followed by City staff for the application and vetting process for service on the City of San Diego's Boards and Commissions.
13	118.1	SDCERS board applications should be shared with the Business and Governance Committee of the SDCERS board.	Per the 1/28/08 Mayor's 6th Kroll Status update this item is completed (no additional comments related to this item made).	Audit concluded this item has not been fully remediated. See recommendation number 6 on page 12 of the report.

Item Count	Kroll Item No.*	Description of Recommendation	Remedial Actions Taken by Management	Summary of Audit Testing
14	NA[1]	San Diego City Employees' Retirement System (SDCERS) operates as a retirement system trust fund under Section 401(a) of the Internal Revenue Code of 1986, as amended ("IRC"). As a plan qualified under Section 401(a), SDCERS receives tax exemption, pursuant to IRC Section 501(a), on monies accruing within the pension trust fund. The City may not have complied with the IRC in the manner in which it funds and administers healthcare benefits for employees. Between 1982 and 2005, the use of SDCERS Surplus Earnings to fund retiree healthcare benefits and the administration of the retirement healthcare program through SDCERS may have violated the qualification requirements of IRC Section 401(a) and IRC Section 401(h). The recommendation is to implement the applicable remedial actions as outlined in the Mayor's August 24, 2006 responses to the Kroll Report.	Per a 12/17/07 e-mail to Audit from SDCERS Internal Auditor, "The City's practice of designating pension trust fund earnings to be used for retiree healthcare benefits has stopped. Fiscal Year 2003, using Fiscal Year 2002 "surplus earnings", was the final year that funds were designated from the City's Annual Required Contribution and credited to the 401(h) account to be used for retiree healthcare benefits. Beginning in Fiscal Year 2004, and all fiscal years thereafter, the City of San Diego did not designate any portion its Annual Required Contribution for the payment of retiree healthcare benefits. Remaining carryover funds in the 401(h) account from prior fiscal years were fully expended in January 2005. Since January 2005, retiree healthcare benefits have been paid from an OPEB Retiree Healthcare Fund that the City created and funded separately and apart from the Retirement Trust Fund."	This item/finding deals with the funding of retiree healthcare benefits and the legality associated with the funding source. The recommendation given by KPMG is to implement the applicable remedial actions as outlined in the Mayor's August 24, 2006 responses to the Kroll report. The applicable remedial actions in the Mayor's response pertaining to retiree healthcare benefits and funding are Kroll items 106, 107, and 107.1. Audit testing concluded items106, 107 and 107.1 have been successfully remediated.

*Number assigned by Mayor in August 24, 2006 memo

[1] Item is from KPMG 2003 Report. Audit and ICOFR tracking number is 76.250.

SDCERS

San Diego City Employees' Retirement System

MEMORANDUM

DATE: August 22, 2008

TO: Eduardo Luna, City Auditor

FROM: Mark Hovey, SDCERS Chief Financial Officer

SUBJECT: SDCERS Response to Audit Report Regarding Kroll Remediation

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This memorandum responds to the recommendations we reviewed in the draft audit report regarding Kroll Remediation actions for SDCERS activities.

The following are SDCERS responses for items under our purview.

Recommendation #1 regarding Kroll Item 99:
To ensure compliance with the Kroll report recommendation, SDCERS should amend its Board policy to include a ten year limitation on continuous service on contracts for actuarial valuation services, and ensure future renewals with Cheiron, Inc are in compliance with this policy.

SDCERS' Response
The terms under which service providers are retained are solely within the purview of the SDCERS Board of Administration. SDCERS' current Board rule permits contracts to have a term of three years, with two optional one-year extensions, unless the party hiring the provider determines otherwise. In June 2006, SDCERS entered into a contract with our actuary for three years, with a five-year renewal option, which was consistent with the "determine otherwise" provision of our Board rule. In July 2008, the Board approved a three-year renewal with Cheiron which is still within the "determine otherwise" provision of the Board rule.

SDCERS plans to amend by December 31, 2008 its policy for hiring service providers such as Cheiron to require a re-bid after five years.

Recommendation #2 regarding Kroll Item 100 and 101:
SDCERS should modify their Investment Policy Statement to provide a requirement for all contracts with investment consultants and fund managers to include a clause requiring an annual written disclosure of all financial and personal relationships that may give rise to an actual or perceived conflict of interest and any failure or delay in filing the annual disclosure will result in a penalty, including termination of services.

SDCERS' Response

SDCERS' current contracts with Investment Consultants and Investment Managers include an explicit provision that the service provider disclose in writing all financial and personal relationships that may give rise to an actual or perceived conflict of interest. The contract requires the service provider to execute annually a written certification that they are in compliance with SDCERS Vendor's Conflict of Interest Policy. Finally, the contract provides SDCERS the right to terminate the contract within 30 days for failure to comply with contractual provisions. These contracts fully comply with the Kroll report recommendation. Staff will recommend modifying the Investment Policy Statement to include the contractual provision requiring providers to submit an annual written certification of their compliance with SDCERS' Conflict of Interest policy.

Recommendation #3 regarding Kroll Item 120.1:

SDCERS should notify City management that they do not intend to include in their CAFR a report from each of its standing committees on significant activities during the year, and that the remediation status of this item should be changed from "Complete" to "Not to be implemented".

SDCERS' Response

SDCERS has decided not to include separate reports from its standing committees in its CAFR. As noted by the City Auditor, these reports are neither required nor suggested by the Governmental Accounting Standards Board for presentations of pension fund financial statements. Consistent with this, to SDCERS' knowledge, no other California public pension fund includes such reports in their CAFRs. SDCERS' CAFRs do include transmittal letters from the CEO and Board President, disclosure Notes to the Financial Statements, and complete and comprehensive Investment and Actuarial Sections. SDCERS agrees that the remediation status of this item should be changed from "Complete" to "Not to be implemented."

Cc: D. Wescoe
B. Wilson

THE CITY OF SAN DIEGO

MEMORANDUM

DATE: August 26, 2008

TO: Eduardo Luna, City Auditor

FROM: Mary Lewis, Chief Financial Officer

SUBJECT: Response to Audit Report of Kroll Remediations for SDCERS

This memorandum responds to the recommendations in the draft audit report that reviewed management's actions to remediate the internal control weaknesses identified by the Kroll Report.

The following are the City's responses for items under the purview of City management.

Recommendation #3:
SDCERS should notify City management that they do not intend to include in their CAFR a report from each of its standing committees on significant activities during the year, and that the remediation status of this item should be changed from "Complete" to "Not to be implemented".

City of San Diego Response:
As stated, including full committee reports in a financial statement is not standard GASB practice. The City expects, however, that the intent of the Kroll recommendation will be fully implemented by SDCERS disclosing significant committee activities in the SDCERS CAFR. As such, the City believes that this recommendation is being implemented.

Recommendation #4:
The Mayor's Office should take appropriate actions to resolve the outstanding issues with the draft "Improper Influence" ordinance so that the City Council can pass/adopt the ordinance. Additionally, until such time as the ordinance is adopted by City Council, the status of this item should be amended from "Complete or Substantially Complete" to "In Process".

City of San Diego Response:
The City is working on proposed language and will present a revised ordinance to the City Council by the end of calendar year 2008.

Recommendation #5:
The Mayor's Office should take the steps necessary to fill all SDCERS' Board vacancies as soon as possible. Additionally, the status of Kroll items 115, 116 and 117 should be changed from "Complete' to "Not to be implemented".

City of San Diego Response:
The City is currently working to fill the single board vacancy that now exists and two reappointments are under consideration. The appointments and reappointments will be completed within three months. Filling positions on the SDCERS Board is challenging due to the City's detailed disclosure requirements for board service. In addition, the City suggests amending the above recommendation to the following: "the status of Kroll items 115, 116, and 117 should be changed from "Complete" to "Not to be implemented at this time."

Recommendation #6:
The Office of Appointments to Boards and Commissions should incorporate into their Board selection policies/procedures, language requiring that all applications for final candidates to serve on the SDCERS' Board be forwarded to the SDSCERS Business and Governance Committee.

City of San Diego Response:
The City has established a policy and procedure for the SDCERS Board appointments whereby applications will be sent to the SDCERS Business and Governance Committee. The new policy and procedure follows:

> "Upon the City Council's confirmation of the candidate(s) who will serve on the SDCERS Board, the application(s) will be forwarded to the SDCERS Business and Governance Committee via the SDCERS Administrator (currently David Wescoe)."

This policy will be implemented when the current vacant position on the SDCERS Board is appointed by the Mayor and confirmed by City Council.

I appreciate the opportunity to respond to the draft report. Please contact me if you have any further questions or require additional clarification.

Mary Lewis

ML/slh

cc: Jay M. Goldstone, Chief Operating Officer
Greg Levin, City Comptroller
Kyle Elser, City Audit Manager