FOR IMMEDIATE RELEASE
August 24, 2006

FACT SHEET

SANDERS EMBRACES KROLL REMEDIAL RECOMMENDATIONS AS "OPPORTUNITY TO MOVE CITY FORWARD"

Vowing to become an example for the nation, Mayor Jerry Sanders today enthusiastically embraced all of Kroll's 121 remedial recommendations for the reform of the City's financial and managerial systems. Calling it a "once-in-a-generation opportunity" to reform City government, the Mayor committed himself to implementing the recommendations over the next 30 months.

> "We now have an opportunity to embrace reform and serve as an example of how a city can credibly get its affairs in order and move on to a very productive future. In summary, we can be victims and obstructionists or we can be pioneers. I choose to be a pioneer."
>
> Mayor Jerry Sanders

The Mayor put forward his plan of action in a detailed 38 page report to the City Council. In it, the Mayor provides thorough answers to include timelines and estimated costs for each of the 121 recommendations in 33 different categories, as follows:

Remedial Category	Recommendations	Remedial Category	Recommendations
Oversight Monitor	6	Interest Controls	6
Organizational Structure	8	Personnel	1
Staff Qualifications	3	Procurement	1
Audit Committee	7	Redevelopment Auth.	1
Auditor General	11	Reconciliation of Accts.	3
Independent Auditors	6	Retirement Benefits	1
Ethics	1	Risk Management	2
Budget Policies	3	Training	7
City Actuarial Services	2	SDCERS Fin. Reporting	1
Deferred Maintenance	1	SDCERS Int. Controls	1
Disclosure	5	SDCERS Act. Services	1
Financial Reporting	12	SDCERS Invest. Adv.	2
Forecasting/Projections	1	SDCERS Fin. Reporting	1
IT/Financial Reporting	6	City Funding/SDCERS	9
IT/Email	1	SDCERS Org. Structure	2
Interest Allocation	1	SDCERS Staff Qualif.	1
		SDCERS Board Struct.	7

The City Council will consider the Mayor's plan at a specially called meeting on Wednesday, September 6th at 2pm.

Power of the Strong Mayor

- Stating that many of the Kroll recommendations have been around for years and were the product of various citizen committees, the Mayor distinguished his administration by saying that he would use his strong mayor powers to bring about the will "to make changes."

What Implementation Gets for City

- The Mayor cited that the implementation of the remedial plan will definitely result in far greater transparency in the City's financial reporting systems and practices; it will make City government more efficient and accountable to our citizens; and implementation of the plan will introduce sorely needed internal financial and managerial controls.

- The Mayor also stated that adoption of these actions will send positive messages to the bond rating agencies and the financial markets that the City understands the depth of its past wrong doing **and** that it is prepared to institute corrective actions so that the City never makes the same mistakes.

- All of these actions will give the City the ability to once again access the public credit markets so that it can obtain much needed capital for public infrastructure projects.

> "I will be the ultimate monitor that ensures our compliance. While I didn't create these problems, I am responsible for fixing them. It will be my legacy to leave behind a better City government than the one that I inherited."
>
> Mayor Jerry Sanders

Implementation does NOT solve City's Financial Problems/Only Reform Will

- Mayor Sanders emphasized that the implementation of the remedial plan will not solve the City's financial problems. "Only fundamental changes to the ways in which we budget – and more importantly, account for long term liabilities -- will solve the City's problems," stated the Mayor.

- As such, the Mayor intends to present the City Council with the City's first-ever Five Year Budget Plan. The plan will include the estimated costs of the remedial actions as well as the other related line items. The Mayor will present this plan to the Council by the end of the year.

- Early estimates show that it will cost upwards of $45 million to implement the remedial actions. These estimates are preliminary by nature and will change as they are refined.

- Beginning a year long conversation with the City's residents, the Mayor said that the changes that he will propose will require sacrifice on the parts of all, to include the City's dedicated employees and residents. "I think that it's safe to say that I envision a much smaller City workforce in the future. I also believe that City services will have to match our resources and our priorities," stated the Mayor.

Mayor will NOT Support Tax Increases to Solve City's Problems

- The Mayor made clear that he will not propose or support any tax increases. "I think that voters appropriately expect that government should be able to live within its means, just as citizens do in their own homes across our City. Consequently, we will have to make cuts to the costs of operating City government," stated Mayor Sanders.

Timeline for Reassessing Financial Markets

- The Mayor today also announced his plan for re-accessing the public credit markets. Assuming the necessary deadlines are met, the City should have cash in hand by June 2007 to finance critical infrastructure projects.

> **"The time to act is now."**
> Mayor Jerry Sanders

OFFICE OF MAYOR JERRY SANDERS
CITY OF SAN DIEGO

MEMORANDUM

Date: August 24, 2006

To: Honorable Members of the City Council

From: Mayor Jerry Sanders

Subject: Responses to the Remedial Recommendations Found in the Kroll Report

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After careful review of the Kroll Report dated August 8, 2006, staff identified over 120 remedial recommendations offered by the Audit Committee. This memorandum takes these recommendations and groups them by subject matter. In many instances, one response will cover a number of recommendations. At the end of each grouping, there is a brief statement of the fiscal impact. At the end of this memorandum, there is a cumulative fiscal impact followed by a calendar summarizing the implementation timeline.

Over the course of the next 30 months, my staff and I will implement these recommendations. Key to this implementation will be a thorough analysis to insure that each action taken complies with the Municipal Code, the City Charter, the California Constitution as well as any other applicable state and federal requirements.

Accepting these recommendations is only the first step toward the road to fiscal recovery. It will set in place systems that will increase the likelihood that practices of past administrations will not happen again. The remedial steps found in the Kroll report have satisfied both KPMG and Macias Ginni & O'Connell, the audit firms performing the City's fiscal years 2003, 2004, 2005 and 2006 financial audits. Both have indicated that based upon the City's responses to these recommendations and the completion of further audit work, they will be ready to issue their opinion letters which will lead to the release of past overdue City audits.

Implementing these remedial steps alone, however, will not address the fiscal challenges facing the City. Nor will implementing these recommendations necessarily address all concerns of the SEC. Again, this is only the first of many steps. Concurrent with this, the City will finish the development of a long range Financial Recovery Plan. This Plan will continue the development of an open and honest budget that was the basis for the fiscal year 2007 budget. It will include accurate revenue and cost projections, paying down the Unfunded Actuarial Accrued Liability, identifying deferred maintenance requirements and

providing adequate funding to begin seriously addressing these unmet needs. Also included will be the implementation of a new financial system, the building of adequate reserve levels, and improve the funding level for the post employment medical coverage.

With this as a backdrop, the following represents management's responses to the numerous remedial recommendations suggested by Kroll. Following this report are a series of Attachments that set out both timelines and financing details for these recommendations.

Cc: KPMG
Macias Ginni & O'Connell
City Attorney
Chief Operating Officer
Chief Financial Officer
Independent Budget Analyst
Securities & Exchange Commission
Department of Justice
SDCERS
Bond Rating Agencies

OVERSIGHT MONITOR

1. Appoint a Monitor to oversee the implementation of and compliance with the Remediation Plan. (Pages 263 & M-14)

2. The Monitor should be selected by the Mayor in consultation with the City Council and subject to the approval of the SEC and should be an independent person of suitable standing, independence and experience for the assignment. (Pages 263 & M-14)

3. The Monitor should have complete and unfettered access to all City and SDCERS personnel and records. (Pages 263 & M-14)

4. The Monitor should make quarterly reports to the City and the SEC on the City's progress. (Pages 263 & M-14)

5. The Monitor should serve a term of no less than three years and should be provided adequate resources to carry the duties of his office. (Pages 263 & M-14)

6. The SEC should have the right, upon request, to expand the scope of the Monitor's duties following consultation with the City. (Pages 263 & M-14)

Response: City Management agrees with these recommendations. The Mayor is in the process of identifying a Monitor to oversee the implementation of the Remediation Plan. The Mayor will consult with the City Council prior to conclusion of the selection process. This individual will need to be approved by the SEC. Staff will work closely with the monitor to ensure that he/she has all requested information. It is anticipated that an agreement with the monitor will be for a three year period and the specific scope and duties will be worked out once this person is confirmed.

Fiscal Impact

The cost associated with implementing these recommendations is still being developed; however, in similar situations in the private sector, the cost of a monitor could be $3 to $4 million over the three year period.

ORGANIZATIONAL STRUCTURE

7. Centralize accountability for the accuracy and credibility of the City's financial reporting under the CFO. The areas of responsibility would include, a City Comptroller, a Director of Financial Reporting, the Financial Management Director, Director of Debt Management and City Treasurer. (Pages 245 & M-1)

8. The Director of Planning, Budgeting and Financial Analysis (Financial Management Director) should report directly to the CFO and have principal responsibility for preparing an annual budget, a monthly budget with comparisons of budget to actual results year-to-date, analyses of variances and a quarterly

report to the City Council and public setting forth budget versus actual results. (Pages 246 & M-2)

9. The City Treasurer should report to the CFO and have principal responsibility for all treasury functions for the City. (Pages 246 & M-2)

10. The CFO should have primary responsibility for, and have as direct reports, personnel with functional authority over accounting and financial analysis, treasury, planning and budgeting and financial reporting. This should include authority over those responsible for all information systems required by these functions. (Page M-1)

11. The Budget Director should report directly to the CFO and have principal responsibility for preparing an annual budget, a monthly budget with comparisons of budget to actual results year-to-date, analyses of variances, and a quarterly report to the City Council and public setting forth budgeted versus actual results. The Budget Director's Office should serve as a resource for financial analysis, planning assistance, and services to other City departments and agencies. (Page M-2)

12. The City Treasurer should report to the CFO and have principal responsibility for all treasury functions for the City. The Office of the Treasurer and the duties assigned to that Office shall be as otherwise described in the City Charter. (Page M-2)

Response: City Management agrees with these recommendations. This was one of the first actions taken by the Mayor upon taking office. An evaluation of required Charter amendments will be completed in time for the June 2008 general City election. Until the voters have an opportunity to vote on these changes, this recommendation will be accommodated administratively within the parameters permitted by the Charter.

The City's current Financial Management Director (designated the Director of Planning, Budgeting and Financial Analysis by Kroll) reports to the Chief Financial Officer. The principal responsibilities of this position include those outlined in the recommendation of the Report. The principal responsibilities include the preparation of the annual budget, the quarterly expenditure reports that include a comparison of actual results to budget year-to-date, an analysis of variances, and forecasts of annual expenditures and revenues based on actual results. These reports explain significant revenue and expenditure variances and highlight trends that may require remediation. First quarter reports are being developed for fiscal year 2007 and will be presented to City Council and the public in October 2006. Currently, according to the City Charter, the Auditor and Comptroller is to prepare and submit monthly reports to the City Council and to the public presenting the actual expenditures at the end of the previous accounting period and the percentage of annual budget expended. As part of the new organization structure, the preparation of the monthly reports will become the responsibility of the Director of Financial Management. Until the full implementation of organizational changes recommended by Kroll are completed, the Financial Management

Director will work with the Auditor and Comptroller to issue a joint monthly report that includes a variance analysis by department and fund.

Effective in January 2006, the City Treasurer began reporting to the Chief Financial Officer. The City Treasurer has responsibility for all treasury functions of the City, including cash management, business licenses, investments, and collections. The responsibility for debt management has been segregated into a separate department called Debt Management (formerly known as Financing Services). This Department also reports directly to the Chief Financial Officer.

Please see Attachment "A" for an organization chart.

13. Establish the position of City Comptroller responsible for accounting and financial reporting, including preparation of the CAFRs and reporting to the CFO. (Pages 245, 246 & M-2)

14. Establish the position of Director of Financial Reporting responsible for the preparation of the City's periodic financial statements. (Pages 246 & M-2)

Response: City Management agrees with these recommendations; however, believes they will require an amendment to the City Charter and perhaps the Municipal Code. Working with the City Attorney's Office, staff will develop an interim solution that does not violate the relevant provisions of the current Charter. Prior to the June 2008 general election, staff will return to the City Council with proposed language to amend the Charter in order to accommodate these recommendations on a permanent basis.

Fiscal Impact

The establishment of two new positions, City Comptroller and Director of Financial Reporting, will result in no net increase to the City's budget. Funding for these positions will come from savings from other vacant positions that will not be filled. In addition, the Mayor has already implemented the fundamental reporting structure so that all financial activities and responsibilities flow through the CFO, thus not requiring any additional funding.

STAFF QUALIFICATIONS

15. The CFO should have significant experience with governmental operations, including accounting, financial reporting and applicable disclosure standards, rules and regulations. The CFO should in particular have experience in the preparation of a CAFR in accordance with governmental accounting standards and offering statements for a municipal issuer. (Pages M-1 to M-2)

16. The Comptroller should have significant experience in governmental accounting, including in the preparation of CAFRs in accordance with GASB and other applicable accounting and financial reporting standards, rules and regulations; should in particular be familiar with federal rules and regulations applicable to the

receipt of federal assistance and the issuance of public securities; and should also be competent to design, implement and operate an effective system of internal controls over financial reporting and disclosure. (Page M-2)

17. The Director of Financial Reporting would report to the Comptroller and would be responsible for the preparation of the City's periodic financial statements. This person should also have experience in the preparation of the CAFRs in accordance with GASB and other applicable accounting standards, rules and regulations. (Page M-2)

Response: City Management agrees. The current CFO meets these standards. As the City moves forward with the establishment of new positions, required skill sets and qualifications will be incorporated into the job specifications and will be a major criteria used in the recruitment process.

Fiscal Impact

There is no cost associated with implementing these recommendations.

AUDIT COMMITTEE – FORMATION AND DUTIES

18. The City should establish a three member Audit Committee comprised of two members from the public and one City Council Member. The public members would be nominated by the Mayor and confirmed by the City Council. (Pages 251 & M-6)

19. The City's Financial Reporting Oversight Board should be eliminated as redundant to the Audit Committee. (Page M-6)

20. The Audit Committee should establish a written charter. (Pages 251 & M-6)

21. The Audit Committee should meet quarterly, or more often if necessary, with the City's independent auditors, the City's Auditor General and the CFO. (Page 252)

22. The Mayor, CFO, City Attorney and City Council should have the authority to make requests of the Audit Committee and Auditor General to perform internal audits of material matters they reasonably believe to be warranted. (Page 252)

Response: City Management agrees with these five recommendations subject to discussions with the Securities and Exchange Committee (SEC). The City Council already established the Financial Reporting and Oversight Board. This Board was never activated because of the role of the Audit Committee staffed by Kroll. Following discussions with the SEC, staff will bring to the City Council an amendment to the Ordinance 191320 in order to convert the Financial Reporting and Oversight Board to the Audit Committee. The duties and responsibilities of the Audit Committee will take into

consideration the recommendations made in the Kroll Report as well as discussions/directions from the SEC. In addition to the positions sited above, it is acknowledged that the Independent Budget Analyst may also make requests of the Audit Committee or Auditor General. **Within 60 days following the Ordinance amendment**, names of two community appointees will be recommended to the City Council for approval. The actual meeting schedule of the Committee will be established by the Audit Committee itself. Once established and the seats filled, staff will work with the Audit Committee to assist in the establishment of a written charter.

23. With the assistance of the CFO and Auditor General, the City's independent auditors would be retained by, report to and take direction from the Audit Committee. (Page 252)

Response: City Management agrees. Currently the City has retained its independent auditors through the fiscal year 2005 audit and staff will be recommending the continuation of this agreement for the fiscal year 2006 audit. Depending upon the timing for the seating of the Audit Committee, this recommendation could be implemented for the selection of the independent audit firm for the fiscal year 2007 audit. **Under no circumstance will this recommendation be implemented later than for the fiscal year 2008 audit**.

24. The Audit Committee should have responsibility for the establishment and monitoring of effective policies and procedures for dealing with "whistleblower" complaints, including an internal hotline. (Pages 252 & M-6)

Response: City Management agrees. Specific policies and procedures will be established by the Office of Ethics and Integrity by **October 2006**. These will identify the specific roles and responsibilities of the Audit Committee for monitoring and handling whistleblower complaints. This will include defining which types of complaints will be referred to the Audit Committee and which will be handled directly by Office of Ethics and Integrity. Once the Audit Committee is in place, these policies and procedures will be reviewed by the Committee and the Audit Committee can recommend changes which will be incorporated into the policies.

Fiscal Impact

It is anticipated that members of the Audit Committee will not be compensated for serving on the Committee. A budget will need to be developed, however, to cover costs that may be incurred in the course of carrying out their duties. It is estimated that a budget for this Committee would be around $150,000 per year and would be incorporated into the budget of the Auditor General.

AUDITOR GENERAL – ESTABLISHMENT AND RESPONSIBILITIES

25. Create a new position of Auditor General with responsibility for internal audits of the City's internal controls, financial accounting, reporting and disclosure; operations; and fraud, waste and abuse. This person would be nominated by the Mayor and confirmed by the majority of the City Council. (Pages 250 & M-5)

26. The new Auditor General should report to the Audit Committee no less than on a quarterly basis and periodically to the City Council and should submit annually to the City Council a public report of his/her activities. (Pages 250 & M-5)

27. The Auditor General would serve a term of 10 years, but could be removed by a two-thirds vote of the Audit Committee or by a vote of at least three-quarters of the City Council. (Pages 251 & M-5)

28. The Auditor General should report to the Audit Committee the results of any investigation and disposition of such complaints. (Page 252)

29. In accordance with the International Standards for the Professional Practice of Internal Auditing, the Auditor General should establish risk-based plans to determine the priorities of the internal audit activity. (Page M-17)

Response: City Management agrees with these recommendations; however, believes they will require an amendment to the City Charter. Working with the City Attorney's Office, staff will develop an interim solution that does not violate the relevant provisions of the current Charter.

Prior to the June 2008 general election, staff will return to the City Council with proposed language to amend the Charter in order to accommodate these recommendations on a permanent basis.

30. The City should require the Auditor General to adopt a comprehensive risk assessment and planning process that actively addresses financial reporting, accounting activities, and other issues. (Page M-25)

31. The Auditor General should use a systematic and disciplined approach based on a risk assessment to select audits. This risk assessment should be completed at least annually. The department should evaluate and contribute to improving risk management, controls, and governance processes. (Page M-17)

32. The department should base audit plans on both subjective analysis of comments from management and objective analysis of financial and operating data. (Page M-25)

Response: City Management agrees. Part of the responsibilities of the Auditor General will be to formally prepare a Five Year Risk-Based Audit Plan for the purpose of prioritizing and addressing financial reporting, accounting activities, and other issues. This Plan will be completed utilizing the methodology developed by the Institute of Internal Auditors. This

methodology will incorporate the concept of "audit materiality" which is based primarily on a ranking of City activities via an "audit risk analysis". **The actual timetable for the completion of this remedial recommendation will be determined by the Auditor General.**

Annually the Risk-Based Audit Plan will be updated as priorities and issues change for the City. By assigning a numerical value (between 1 and 5) to such factors as total budget, existence of management controls, complexity of operations, volume of transactions, degree of public interest/scrutiny, etc., the Auditor General will determine which activities should receive audit attention annually, bi-annually, every three years, and every five years. The input of department heads and financial analysts in the audit priority ranking process will be solicited and incorporated with empirical data gathered via the "audit risk analysis".

33. The internal audit activity should focus on improving the control systems related to the reliability and integrity of financial and operational information; the effectiveness and efficiency of operations; and safeguarding assets. (Page M-17)

Response: City Management agrees. As the guardian of the City's internal control structure, the internal audit function will focus on the reliability and integrity of financial and operational information, the effectiveness and efficiency of operations, and the safeguarding of assets. Details will be developed and further discussion of this remedial recommendation will occur once the Auditor General has been appointed.

34. Elected officials, their staff, and the City's senior management must be considered by the internal audit function. (Page M-17)

Response: City Management agrees. Insofar as the basis of all internal controls resides in a strong and positive control environment, and insofar as the effectiveness of the control environment is dependent directly upon the attitudes and behavior of the organization's top officials, the elected officials, their staff, and senior management will be considered by internal audit.

35. The Five Year Risk-Based Audit Plan should be presented to the new Audit Committee and the City's elected officials. (Page M-25)

Response: City Management Agrees. The annual audit plan, upon completion, will be presented on an annual basis to the new audit committee and the City Council.

Fiscal Impact

The establishment of the Auditor General and department is intended to be cost neutral and result in no net increase to the City's budget. Funding for the Auditor General and staff will result from savings transferred from the Auditor & Comptroller Office. A specific budget will be developed as part of the fiscal year 2008 budget and any mid-year budget amendments required to the fiscal year 2007 budget in order to move positions and funding to this new budget will be brought to the City Council at the appropriate time.

INDEPENDENT AUDITORS

36. A reputable independent auditing firm should be retained by the City's new Audit Committee which should in connection with the annual audit of the financial statements of the City for the fiscal year ending June 30, 2008, conduct an audit of the City's internal controls. (Pages 248, M-3 & M-4)

37. The procurement decision involving the selection of an independent auditor is accompanied by a statement of the basis for the selection, including the weight accorded costs and any other factors, and that such statement is maintained as part of the records of the new Audit Committee. (Pages 253 & M-7)

38. The Audit Committee and the City should enter into five-year contracts with its independent auditors. (Pages 253 & M-7)

39. After the initial five-year term, that term could be extended for another five years provided that the audit firm rotates the audit partner responsible for the engagement and the auditor has received an unqualified peer review report on its audits. (Pages 253 & M-7)

40. The independent auditor should not be permitted to serve for more than two consecutive five-year terms. (Pages 253 & M-7)

41. Any firm/bidder should be disqualified as a possible independent auditor if the audit firm directly or indirectly, through any of its principals or employees, has made a campaign contribution to an elected official of the City within two years of the selection or performs other, non-audit services for the City. (Pages 253 & M-7)

Response: City Management agrees with these recommendations. The City currently has a contract with the audit firms of KPMG for the fiscal year 2003 audit and Macias, Ginni & O'Connell for the fiscal years 2004, 2005 and 2006. Until the City establishes its Audit Committee, responsibility for making a formal recommendation to the City Council relating to the selection of auditors will continue to rest with the Mayor. **No later than the audit for fiscal year 2008, this responsibility will be transferred to the Audit Committee, with input from the Chief Financial Officer and Auditor General. In addition, no later than with the selection of the City's next**

independent audit firm, which could be as soon as the fiscal year 2007 audit, but no later than the fiscal year 2008 audit, the City will establish a selection and scoring matrix that takes many qualification factors into consideration. While an important factor in the decision process, price will be only one of several criteria used.

Fiscal Impact

There will be no fiscal impact on the City relating to the implementation of these recommendations.

ETHICS

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. (Page M-6)

Response: City Management agrees. The Mayor, working with the City Attorney, will bring to the City Council amendments to the Municipal Code which will add criminal penalties to discourage improper influence in the public financial reporting process of the City.

Fiscal Impact

There will be no fiscal impact on the City relating to the implementation of this recommendation.

BUDGET POLICIES AND PRACTICES

43. In order to maintain current service levels and address issues such as deferred maintenance, the City must reduce expenditures by improving efficiency, increasing the current revenue base, and seeking alternative revenue sources. (Page M-14)

44. Ongoing expenditures should be supported by ongoing revenues; capital projects should identify all future cost considerations and financial impacts, including direct and indirect costs for each Enterprise Fund; activities supported by user fees should be fully cost recoverable; discretionary General Fund revenues should not

be earmarked; increase the General Fund reserve to the range of 7-10%; budget development should be guided by a long term or strategic plan proposed by the Mayor and adopted by the City Council; and after adoption, annual budgets should be amended only for urgent needs. Specific funding sources should be identified to pay for these needs. (Pages M-14 & M-15)

45. The City should publish, along with the annual budget, the significant assumptions that can materially affect the budget, and a comparison of these assumptions against actual experience in recent years. (Pages 261 & M-12)

Response: City Management agrees with these recommendations. The fiscal year 2007 budget began implementing the budget principals outlined above and will be expanded upon in the future. Significant progress was made in the fiscal year 2007 budget. The budget presented to the City Council was structurally sound and balanced, it accurately accounted for such expenses as overtime, it accurately accounted for all city positions and gave a true and accurate picture of both revenues and expenses.

As City Management begins preparations for the fiscal year 2008 budget process, the City will explore how to best incorporate such sound budget principles as ensuring that discretionary General Fund revenues are no longer earmarked as well as all of the other policies listed in the recommendations above.

The City acknowledges that past budgeting practice did not fully identify all costs or revenues and did not account for the increased operating expenses associated with various capital projects. **A multiyear financial plan is being developed for presentation to the Budget and Finance Committee of the City Council** and will include projected expenditures anticipated after putting into operations the completed capital projects. Other changes to the capital planning and budgeting process will be explored during fiscal year 2007 and recommended changes will be included as part of the fiscal year 2008 budget. This will include the need for developing a multiyear plan for capital projects. **A new General Fund reserve policy will be presented to City Council in October 2006** that identifies a reserve account, separate from the "deep" reserves, which will serve as a contingency for unanticipated expenses approved by City Council. **The Mayor is committed bringing forth budgets to the City Council that will increase the General Fund reserve**. This policy recommendation will be included in the new reserve policy that **will be presented to the full City Council by the end of the year.** The multiyear financial plan will include revenue and expenditure assumptions over a five year period that include high and low growth parameters for major revenues, committed expenditures (including operational costs for new facilities and the annual legally mandated pension contribution).

Finally, **the 2007 Annual Budget will be published by October 2006** and will include assumptions underlying the revenue growth projections. Economic factors such as regional income and population growth, taxable sales and hotel occupancy rates, assessed property valuation, and home sales affecting major revenues such as Sales Tax, Property Tax and

Transient Occupancy Tax are presented. Assumptions regarding statewide economic factors and state legislation that could affect revenues to the City will also be included. The vacancy factor assumptions for the City that were included in the fiscal year 2007 budget will be monitored against actual experience throughout the year. The presentation of significant expenditure assumptions will be expanded in the fiscal year 2008 proposed budget and will be included in the published fiscal year 2008 annual budget. The City of San Diego does not have actual data for fiscal years 2003, 2004, and 2005 to illustrate actual experience against the budget. Once actual data becomes available, these comparisons will be included in the City's published annual budget.

Fiscal Impact

The fiscal impact will be dependent on the implementation of these recommendations.

CITY ACTUARIAL SERVICES

46. The City should periodically, but no less frequently than every three years, retain its own actuary to review the SDCERS actuarial valuation and the assumptions used, and to provide an independent assessment of the valuation and its implications for the City. (Pages 260, M-11 & M-12)

47. The City must retain its own actuary responsible for determining for the City the cost of each proposed new retirement benefit and to issue a report thereon to the City Council before an ordinance is adopted conferring the benefit. (Pages 260 & M-12)

Response: City Management agrees with these recommendations. The City has retained its own actuary to review the assumptions and methodologies used by SDCERS' actuary in calculating the City's ARC. This practice will be continued at least every three years and more often as necessary. **The first results by the City's actuary will be completed by September 2006.** In addition, the Mayor and City Council have placed a ballot proposition on the November election which, if approved, would require any future increases in retirement benefits negotiated by the City be approved by the voters of San Diego. Prior to any item being put before the voters, an actuarial valuation would be completed and the projected cost of any benefit increase known.

Fiscal Impact

The projected cost to retain an actuary is $300,000 depending upon the actual scope of work to be performed.

DEFERRED MAINTENANCE

48. We recommend that the Mayor and the Budget Director establish a process to identify and prioritize deferred maintenance and unfunded procurement needs. The Budget Director should prepare and present a public report identifying cumulative deferred maintenance and unfunded procurement needs during the annual budget hearings. The City's approach to funding deferred maintenance and unfunded procurement should be changed to allow for increased funding in these areas. (Page M-21)

Response: City Management agrees. Presently there is no consolidated or prioritized list of deferred maintenance nor is there a system in place to identify this critical requirement. The Department of General Services, Facilities Management Division, is currently developing a comprehensive restructuring of internal processes to address deferred maintenance requirements. This restructuring effort involves these specific components:

i. Development of a Facility Category Index to identify facilities and assets critical to the mission of the City and prioritize those assets for funding to address deferred maintenance requirements. The estimated completion date to develop this Index is **September 2007**.

ii. Development of an asset inventory to create current inventories of essential infrastructure assets (e.g., Chiller Plants, Boilers, Pumps, High Voltage Switch Gear). The estimated completion of the inventory is **September 2006**.

iii. Collect data on the equipment identified in the asset inventory including maintenance and performance requirements, in order to provide the basis for implementation of a Capital Renewal Program whereby major components are renewed or replaced as part of a predictive replacement program. The assessment phase of this activity provides a current "Baseline" of deficiencies (deferred maintenance requirements) for essential infrastructure. This assessment, subject to funding, will be completed by **January 2008**.

iv. Development of preventive maintenance schedules and staffing requirements. This component is part of the assessment process and focuses on the development of scheduled preventive maintenance standards to minimize sub performance and breakdowns. The estimated completion is **January 2008**.

The Financial Management Director, working in conjunction with Facilities Management, will prepare a report during the fiscal year 2008 budget hearings that includes the assessment data that is available through the process outlined above. In addition, the Multiyear Financial Plan that is being developed for presentation to City Council in October 2006 includes unfunded procurement requirements reported by city departments. This plan will be updated quarterly.

Fiscal Impact

Until a specific list of deferred maintenance needs have been identified and prioritized, staff is unable to project the cost impact to the City's budget. Previous information suggests that there is in excess of $300 million in deferred maintenance needs. A funding strategy will be developed and incorporated into future five-year financial projections.

DISCLOSURE

49. Continue the operations of the Disclosure Practices Working Group (DPWG) and add the CFO not only as an official member but also have this person serve as chair. (Pages 249, M-4 & M-5)

50. The City should assign the responsibilities for preparing public documents and filings to the appropriate City employees. Ultimate responsibility for preparing these City documents cannot be assigned to the independent auditor, disclosure counsel, fiduciary counsel, actuary, or other professionals. (Page M-25)

51. The City Attorney or City Attorney staff member should collect information relevant to public filings and bond offerings and should confirm, in writing, the accuracy of this information in the City's public documents. (Page M-25)

Response: City Management agrees with the above recommendations. **By December 2006**, the Mayor will bring forward an ordinance to amend the Municipal Code in order to redefine the membership of the DPWG. This will include five official voting members, including the Chief Operating Officer, Chief Financial Officer, City Attorney, Auditor General and Independent Budget Analyst (or designees). The proposed ordinance will designate outside disclosure counsel as an ex-officio member. The Mayor will also ask that the by-laws of the DPWG be amended to ensure that that no committee member (including the Chair) can prevent any other committee member from placing an item on the agenda.

Finally, the DPWG has adopted its Controls and Procedures with respect to the preparation of the City's offering documents, including those of related entities. The Controls and Procedures assign responsibility to various members of the finance team responsible for the collection of certification of information relevant to public filings and bond offerings.

52. The City Council should have at least two weeks to review substantially completed drafts of a preliminary offering statement before it is asked to vote to approve the final document. (Pages 263 & M-14)

Response: City Management agrees. Staff will build into the schedule established for public financing transactions adequate time to ensure a minimum two week period for the City Council to review substantially completed drafts of the preliminary offering statement before the Council is asked to approve the final document.

53. The DPWG should report to the City's new Audit Committee. (Pages 249 & M-5)

Response: City Management agrees. Under Section 22.4106 of the Municipal Code, the DPWG is required to submit to the Financial Reporting and Oversight Board an annual evaluation of the City's disclosure procedures and controls. The Audit Committee will replace the Financial Reporting and Oversight Board. The City will amend Ordinance 191320 to implement this recommendation.

Fiscal Impact

There will be no fiscal impact on the City relating to the implementation of these recommendations.

FINANCIAL REPORTING

54. The City budget should be presented by month, by department. (Pages 261 & M-13)

55. At least quarterly, a report should be prepared reflecting budget-to-actual comparisons by department in aggregate, with an explanation of significant variances, to be disseminated to the public. (Pages 261 & M-13)

56. The City budget should present budget-to-actual comparisons by department, fiscal year-to-date, along with variances on a monthly basis. (Pages 261 & M-13)

57. At year-end, a budget should be presented to the City Council containing a final budget-to-actual comparison, along with an explanation of variances by department. (Pages 262 & M-13)

Response: Management agrees with these recommendations. The CFO's office, along with staff from the Auditor & Comptroller's Office, will develop budget to actual, fiscal-year-to-date comparisons by department with an explanation of significant variances. **This report will be presented to City Council and to the public in October 2006 and in subsequent quarters.** After the close of each fiscal year and when actual results become available, the Financial Management Director will develop a year-end report that compares by department the budget to actual results. This report will include an explanation of significant variances by department. **A year end report will be issued jointly by the CFO's Office and the Auditor & Comptroller in October 2006** that provides this comparison and analysis for fiscal year 2006.

With respect to the monthly budgeting, the current financial accounting system is based on pay periods, not months. The City plans to convert its financial accounting to monthly periods. **An analysis of what is required to make this transition using the current financial system will be**

completed by March 31, 2007 and will be either implemented beginning in fiscal year 2008 or concurrent with the implementation of a new financial reporting system. Currently, monthly reports presented to City Council show the annual budget by department, actual expenditures-to-date and the percent of budget expended.

58. The Mayor and CFO should annually include in the City's CAFR a signed management report on the financial statements and disclosures which include a statement of the City's responsibility for establishing and maintaining an effective system of internal control over financial reporting and disclosures; a statement setting forth the City's 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 statements and other information included in the CAFR fairly present in all material respects the net assets and activities of the City for the period presented. (Pages 248, 249 & M-4)

59. The chief executive officer and principal accounting officer of each component unit of the City should include annually with its stand alone financial statements a signed management report substantially in the form described for the Mayor and CFO. (Pages 249 & M-4)

Response: City Management agrees. The Mayor and CFO will sign representation letters relating to the fiscal years 2003, 2004 and 2005 audits. This recommended management report will be in addition to the representation letters and will be incorporated into the City's CAFR with the issuance of the fiscal year 2003 CAFR. In addition, this recommended management report will be included in all component unit financial statements with the issuance of each fiscal year 2005 stand alone statements.

60. City schedules requested by the external auditors should be prepared and internally reviewed before the auditors begin work. As part of a sound financial reporting system, the City should prepare supporting schedules and detail for all major accounts and transactions during the monthly closing process. (Page M-17)

61. The City should report as part of its annual CAFR staff's best estimate of material payments it will be required to make for each of the next five years and in aggregate thereafter, as a result of contractual commitments or other commitments the City reasonably intends to fulfill. This includes expected pension payments, retiree health premium payments, capital expenditures resulting from contractual commitments; material contractual commitments in excess of one year; deferred maintenance to extent quantified; and debt and lease obligations. (Pages 254 & M-8)

62. The City must consider the substance of transactions when identifying the appropriate accounting treatment. For example, paying retiree health benefits from pension plan assets withdrew money from the pension plan. These amounts were not reflected as expenses in the City's CAFR. (Page M-18)

63. The City should develop a procedure, such as using a specific object or index code and preparing a report based on the code, to use the accounting system to directly identify information related to CIP in an automated manner. (Page M-21)

64. The City should increase the length of the 13th period and establish a procedure to review all disbursements made subsequent to year end in excess of a pre-determined threshold. This will assist in properly capturing significant accruals within the correct fiscal year. (Page M-22)

65. The City and Departments should identify routine accruals, such as utility bills, and ensure they are properly recorded at year end. (Page M-22)

Response: City Management agrees. As staff is completing the fiscal years 2003 and 2004 audits, these recommendations will be incorporated for the first time into the fiscal years 2005 and 2006 audits and all audits thereafter. During fiscal year 2008, Staff will establish procedures to assist in identifying information related to CIP as well as improving automation. In addition, the 13th period will be held open longer in order to ensure that all of the necessary transactions get posted, thus reducing the number of post closing entries required each year.

Fiscal Impact

There will be no fiscal impact on the City relating to the implementation of these recommendations.

FORECASTING/PROJECTIONS

66. The CFO and Mayor should submit annually to the City Council as part of the annual budgeting process, a rolling five-year proposed plan that contains major items, including capital expenditures, deferred maintenance, debt payments and other major contractual obligations, major revenues by category and a forecast of gross cash receipts and gross cash expenditures. (Pages 262 & M-13)

Response: City Management agrees. **The first version of a five-year financial forecast will be presented to the Budget and Finance Committee by the end of the year.** This model will serve as the basis for the preparation of the City's fiscal year 2008 budget and all subsequent budgets. This model will be frequently updated throughout each fiscal year and will be presented to the City Council at least two to three times each year.

Fiscal Impact

There will be no fiscal impact on the City relating to the implementation of this recommendation.

INFORMATION TECHNOLOGY – FINANCIAL REPORTING SYSTEMS

67. By June 30, 2007, evaluate the information technology needs of the City, including benchmarking of existing systems against available systems suitable for management of the City's finances and the preparation of timely and accurate CAFRs and budgets. (Pages 247 & M-3)

68. Within 18 months, the City shall have selected a new information system and taken all steps necessary for the system's implementation. (Pages 247 & M-3)

69. Within 36 months, the City's new financial information system shall have been fully tested to ensure effectiveness and efficiency and will be implemented. (Pages 247 & M-3)

70. The City should update its chart of accounts, including elimination of unnecessary accounts and funds. This chart of accounts should be consistent across all functions and funds and consolidate funds where possible. The Comptroller should review the current policies and procedures related to creating funds and accounts. If necessary, the ability to create funds and accounts should be limited. The Comptroller should consider using cost centers, index codes, or projects to achieve separate grant, program, and project tracking. (Pages 247, M-3 & M-16)

71. The City should implement and utilize an automated financial reporting system to prepare the financial statements and complete the year-end closing. The City should maintain documentation supporting adjustments to facilitate the review of financial data. (Page M-15)

Response: City Management agrees with these recommendations. The City has determined that its information systems, including its financial systems, are not suitable for the current and future management of the City's finances and the preparation of timely and accurate financial reports, CAFRs and budgets. City management has taken action to address the risk involved in the manual preparation of financial reports, including the implementation of a decision management system that enables real time access to financial reporting data and the development of automated financial reporting procedures. The City is also analyzing the use of data warehousing and business intelligence tools to consolidate financial and accounting data contained in the City's existing systems, allowing this information to be viewed in a real-time mode, combining information from various systems and across funds, departments, divisions, time periods, job classifications, etc. This technology will continue to be used in the long term even after implementation of a new financial system. **The data warehousing and business intelligence project will be complete in January of 2007, will cost the City approximately $500K** and will be funded using fiscal year 2006 carryover funds from San Diego Data Processing Corporation. **By the second quarter of 2007, the City will select an Enterprise Resource Planning (ERP) software package** that will replace all of the City's core financial systems and will select the implementation consultant and identify and staff an implementation team. The implementation of this system will also facilitate a restructuring of the

City's Chart of Accounts for the fiscal year 2008 budget. With the completion of the selection of a new ERP system, staff will begin the implementation process. **Implementation is expected to begin in July 2007**.

72. The City should invest in capital asset information systems that accommodate CIP to reduce the current reliance on manually prepared spreadsheets. These modifications will reduce the time and expense related to gathering this information, reduce errors, and improve the accuracy of tracking CIP and recording depreciation on completed projects. (Page M-21)

Response: City Management agrees. This recommendation will be incorporated into the new Enterprise Resource Planning (ERP) software package that will replace all of the City's core financial systems.

Fiscal Impact

An accurate assessment of the cost of a new ERP financial system (financial and human resources software) is difficult absent a comprehensive RFP process. However, based upon systems used by like sized cities, it is anticipated that the cost will be approximately $35 million (principal plus interest). This includes the costs associated with the purchase of hardware, licensing agreements for the software system and staff and consultants required to actually implement the software, including re-engineering antiquated City processes.

INFORMATION TECHNOLOGY – E-MAIL SYSTEMS

73. All City "Post Offices" should be centrally operated, maintained, and backed up. Consolidating systems and personnel will improve economy and ease maintenance. It will also ensure consistent data retention systems, policies, and procedures are used for City information. (Page M-26)

Response: City Management agrees. The City began a project in May 2006 to consolidate the City's messaging (e-mail) systems This project will involve migrating the entire City to Microsoft Outlook/Exchange and into one centrally managed system. **This project is expected to be complete in June, 2007.** In addition, the City recently completed a study of e-mail message retention policies. As a result of this study, **the City will be implementing standard retention policies Citywide by December 2006.**

Fiscal Impact

The cost associated with implementing this recommendation is $1.5 million. Funding is available from carryover information technology funds, as well as a portion of the information technology fiscal year 2007 budget.

INTEREST ALLOCATION

74. The interest allocation process should receive sufficient management review. (Page M-16)

Response: City Management agrees and has **implemented** this recommendation already. The interest allocation distribution is performed monthly by Auditor accounting staff, based on the monthly Earned Income reports received from Treasury Investments. Subsequent to posting the interest allocation into the general ledger system, the Auditor's Office is currently performing a secondary supervisory review and sign-off to ensure accuracy. In addition, quality control verification is performed on various funds. These established controls mitigate the risk of interest allocation distribution errors.

Fiscal Impact

There will be no fiscal impact on the City relating to the implementation of this recommendation.

INTERNAL CONTROLS

75. It appears that errors and omissions in the CAFR were caused by a variety of issues identified in the 2006 Report on Internal Controls. While the City has made a number of personnel and process changes since June 30, 2002, it must continue to reorganize and refine its processes and train its personnel in order to improve internal controls. The City needs to reduce to a sufficiently low level the risk of errors or fraud material to the financial statements. (Page M-15)

76. By June 30, 2007 the CFO shall have tested and remediated the internal control weakness identified in the Auditor and Comptroller's 2006 Report and in the management letters of the City's outside auditors. (Pages 248 & M-3)

77. The CFO should submit to the Mayor and City Council, and disseminate to the public, a report that describes testing that has been completed, remediation undertaken, any internal control weaknesses not yet remediated and additional material weaknesses identified. (Page 248)

Response: City Management agrees with these recommendations. The weaknesses identified in the Auditor and Comptroller's 2006 Annual Report on Internal Controls (Report) and in the management letters of the City's outside auditors must be tested and remediated fully. **The internal control weakness identified in the Report will either be remediated or will be in the process of being substantially remediate by June 30, 2007.** Certain control weaknesses are currently being corrected through the implementation of newly developed policies and procedures. Other

weaknesses, however, such as those related to the City's management and financial computer systems are being addressed on a comprehensive basis and will take longer and/or will be tied to the implementation of the new ERP system. In the interim, auxiliary systems and improved manual procedures are being developed and implemented. In addition, **by August 2007**, the CFO, in collaboration with the Auditor General, will prepare and present a report that describes testing that has been completed, remediation undertaken, any internal control weaknesses not yet remediated and additional material weaknesses identified.

78. The Comptroller should review and assess the journal entry preparation and approval process. The duties of preparing and approving of journal entries must be appropriately segregated. The Comptroller should assign ultimate responsibility for journal entry review and approval to an individual within the Comptroller's Office. The Auditor General should analyze the journal entry approval process as part of that office's review of City operations. (Page M-17)

Response: City Management agrees with the Audit Committee's recommendation. During Fiscal Year 2006 the City Auditor and Comptroller reorganized the department along business lines to give Principal Accountants and Division Managers the responsibility as well as the authority to properly manage their areas. In addition, a new Automated Journal Voucher module was designed and implemented to allow staff preparation of an entry and appropriate supervisory approval. Since journal entries are a fundamental accounting procedure they will continue to receive close scrutiny. As recommended above, the Auditor General will be required to prepare a citywide risk assessment, analyze risks, and design appropriate tests and audit procedures to test and help ensure the adequacy of internal controls. Given that the journal entry approval process is a fundamental accounting procedure, and has been identified as a weakness, this process will be reviewed routinely.

79. The City has taken a number of steps to quantify the impact and correct its financial statements resulting from deficiencies in internal controls related to capital asset accounting. The City should continue to monitor the internal controls over these areas to ensure that potential errors in the future are detected and corrected in a timely manner. (Page M-20)

80. A number of deficiencies in the internal controls related to accounting for accounts receivable were identified. The City should develop and implement policies and procedures to reconcile, support, and review period end accounts receivable balances. (Page M-21 & M-22)

Response: City Management agrees. **The City will develop and implement policies and procedures to reconcile, support, and review period end accounts receivable balances by the end of June 2007.** Appendices B and C of the Auditor and Comptroller's 2006 Annual Report on Internal Controls contain numerous citations of Control Weaknesses that currently are being corrected through the implementation of policies and procedures.

Fiscal Impact

Aside from the costs associated with the implementation of a new ERP System, there will be no fiscal impact on the City relating to the implementation of these recommendations.

PERSONNEL

81. The City should develop and follow procedures to improve the creation and maintenance of employee files. All pertinent and required documentation (e.g. authorization to hire, pay rate documentation, IRS Form W-4, U.S. Citizenship and Immigration Services Form I-9, and others) should be centrally gathered and maintained. (Page M-24)

Response: City Management agrees. Procedures and policies have been established for the gathering of all pertinent and required documentation for creating personnel files for all employees. A personnel file is created for all employees and contains all documentation establishing the legal right to work in the U.S. upon hire. Additionally, all documentation regarding authorization for hire, pay rate, employment status, W-4, etc. is maintained in a confidential, secured manner and is available for review or audit when necessary.

Fiscal Impact

There is no cost associated with implementing this recommendation.

PROCUREMENT

82. The City should review procurement procedures to ensure compliance with all applicable policies, the proper segregation of duties, and the proper safeguard of requisition forms. (Page M-24)

Response: In March, 2006, a business process review taskforce recommended the formation of a centralized contracting and procurement department. Now formed and in the process of instituting new protocols and procedures, the new Purchasing & Contracting Department (P&C) is actively working to address identified inconsistencies and the application of contracting and procurement guidelines. With respect to the issues noted in this report, the following actions have been set in place to remediate the noted deficiencies in procurement functions: 1) Effective July 1, 2006, all non-engineering consulting contracts must go through P&C for review and award. P&C will maintain copies of all contracts in a centralized database and handle all renewals and modifications. 2) With all consultant contracts (engineering and non-engineering) awarded and tracked by P&C, there will be controls in place to monitor multiple contracts across

departments for one vendor/consultant. P&C will be responsible for monitoring the awards and advising departments to seek City Council approval when the aggregate total exceeds $250,000. 3) New authorization authorities have been issued across the City regarding City purchases. It has been noted that the purchaser and approver should not be the same person. Purchasing and Central Stores teams have been trained to review these requisitions and bring forward any discrepancies. 4) Currently, the responsibility of the issuance of blank PA2610 form lies within the departments and their supervisory direction. The City has implemented the Procurement Card system to start making purchases on citywide contracts. P&C is in the process of rolling out this program across the City. This program provides much greater oversight, checks and balances, with accounting information available for management, and annual audits. This payment method will be replacing many of the current PA2610 applications. Roll-out of the Procurement Card system is anticipated to be completed in January, 2007.

Fiscal Impact

There is no cost associated with implementing this recommendation. There are projected cost savings resulting from this new structure. It is estimated that these savings will be about $3 million.

REDEVELOPMENT AUTHORITY

83. The Redevelopment Authority should develop necessary processes to obtain relevant information from the management companies. It must obtain data related to the purchase or sale of property and the borrowing or repayment of debt in a timely manner to accurately report assets and liabilities. (Page M-20)

Response: City Management agrees with this recommendation. The Redevelopment Agency is currently upgrading its systems and procedures to better track all items within the department, including data relative to the purchase and sale of assets and the tracking of liabilities. **This process will be completed by June 2007.** The Agency is also upgrading its property management processes. **This project should be completed by December 2006.**

Fiscal Impact

There is no cost associated with implementing this recommendation.

RECONCILIATION OF ACCOUNTS

84. The City must develop an improved cash reconciliation process, which is more automated, documented, and complete. The revised process must support accuracy, timely completion, and improved ease of review. (Page M-16)

85. The City should develop and implement a timely and less cumbersome bank reconciliation process to clearly reconcile bank and the general ledger balances. The improved process should facilitate timely completion, ease of review, correction of errors, and enhance communication between the Comptroller's and Treasurer's staff. (Page M-16)

86. City Departments should reconcile all accounts receivable and deferred revenue accounts to supporting information at period ends. Supervisors should review these reconciliations for completeness and accuracy. (Page M-23)

Response: City Management agrees. The cash reconciliation process has been untimely and inaccurate. Part of the solution to this problem will be the investment in a financial system that will allow the City to reconcile the general ledger directly to the bank in an accurate and timely manner. In the interim, management will work to revise current policies and procedures to strengthen internal controls over the cash reconciliation process. This will include acquiring treasury software to automate the bank reconciliation process for the City's controlled disbursement accounts. In addition, management will replace the current 3-way reconciliation with a new reconciliation process which will clearly identify the reconciling items between the general ledger and the bank. With the consolidation of the bank reconciliation process to the Treasurer's Office, there will be the need to hire one additional staff position. Bank reconciliation will be completed on a monthly basis.

Fiscal Impact

There is no cost associated with implementing these recommendations. There will be a need to add one additional staff to the Treasurers Office; however, funding for this position will come from vacancies that exist elsewhere in the organization.

RETIREMENT BENEFITS

87. The City Council and employees should develop realistic retirement plan parameters for future City hires. This includes positioning the City to attract and retain the talent needed to meet the citizens' expectations for services, not be viewed as providing excessive benefit levels, and creating a plan the City can afford. (Page M-25)

Response: Agree. The City has now started a comprehensive evaluation of the City's compensation, health/welfare benefits, and retirement programs. As part of the City's assessment of retirement programs, the City's actuary will

assess the cost implications of formula changes to the existing retirement system. All of these evaluations will sequentially address all areas in a timeframe that will allow consideration of it findings in the appropriate future meet and confer processes and will cover not only future employees, but current employees as well. **The compensation and health/welfare benefit assessment will be complete by November 2006. The actuarial assessment of formula changes to the existing retirement system will be complete by October 2006. The retirement program assessment will be complete by first quarter of 2007.**

Fiscal Impact

The cost of the compensation and health/welfare benefit study is estimated to be $100,000. The cost of the actuarial assessment of formula changes to the existing retirement system is encompassed in the existing contract with the City's actuary. The retirement program assessment RFP has not yet been finalized; however, it is anticipated that the cost for that assessment will be approximately $300,000.

RISK MANAGEMENT

88. The Risk Management department should have responsibility for tracking all claims and cases against the City. Formal procedures to monitor the adequacy of case reserves and general litigation estimates should be implemented. Such procedures should include an established communication process between the Risk Management department, the CFO, Auditor General, and the City Attorney. This communication should take place at least once each quarter, and is particularly important for accurate year end financial reporting purposes. (Page M-23)

Response: Management agrees with this two part recommendation. The first is creation of a formal procedure to monitor the adequacy of case reserves and general litigation estimates. Risk Management agrees with this observation and with the City Auditor, has already implemented new procedures to address this issue. Specifically, the Claims & Insurance Manager has created a schedule of all claims over $100,000. The list will be disseminated, via the Deputy Litigation Manager, to all litigators. The litigators will be responsible for filling in exposure amounts and determining whether losses are probably or reasonably possible. Quarterly meetings will be held between the Deputy Litigation Manager, the Claims & Insurance Manager, and a representative from the Auditor and Comptroller's Department to discuss the exposure amounts. This process may be modified upon the implementation of a comprehensive case management system by the City Attorneys office.

The second issue is that Risk Management should have responsibility for tracking all claims and cases against the City. Although the Public Liability division of the Risk Management department tracks all tort claims and suits

against the City of San Diego, pursuant to the provisions of the Government Code, there is currently no procedure in place to monitor the City's potential exposure arising out of its non-tort legal obligations, e.g. regulatory compliance enforcement actions (water, environmental, etc), land use matters involving eminent domain and inverse condemnation, actions which seek non-monetary relief, civil penalties, fines, taxes and assessments and contractual disputes arising out of change orders and/or construction contracts. Risk Management is working with the Chief Financial Officer to establish a process with respect to these non-tort liabilities which are far more ranging and which may have a considerable fiscal impact on the City.

89. The City should improve monitoring of Workers' Compensation cases and ensure that payments are made in a timely manner to avoid penalties. (Page M-24)

Response: Management agrees with this recommendation. This is two separate issues. The first is the creation of a formal procedure to monitor the adequacy of case reserves and general litigation estimates. Risk Management agrees with this observation and with the City Auditor, has already implemented new procedures to address this issue. The second issue is that Risk Management should have responsibility for tracking all claims and cases against the City. Risk Management is working with the Chief Financial Officer to establish a process with respect to these non-tort liabilities which are far more ranging and which may have a considerable fiscal impact on the City. **New procedures will be in place by June 2007.**

Fiscal Impact
There is no cost associated with implementing this recommendation.

TRAINING

90. The City (CFO) should develop an adequate and effective training program for finance employees to ensure that they maintain competency and remain current in such areas as financial management, external and internal financial reporting and reliable public disclosure. (Pages 246, 247 & M-2)

91. MWWD employees should receive special training directed at ensuring the City complies with all contractual requirements, laws and regulations and reporting any noncompliance to the appropriate individuals or entities. (Pages 247 & M-2)

92. Tailored training for all individuals who are currently employed by the City who were members of the Metropolitan Wastewater Department at any time from 1995 to 2004, the period of the City's noncompliance with its SWRCB grant and loan covenants and its violation of the Federal Clean Water Act should also be developed. The Metropolitan Wastewater Department employees should receive special training directed at (I) ensuring the City complies with all contractual

requirements, laws and regulations, and (ii) reporting any noncompliance to the appropriate individuals or entities. (Pages M-2 to M-3)

93. The City should educate the employees responsible for recording sewer invoices on how to identify the appropriate supporting documentation for Municipal and Metropolitan allocations in order to reduce the likelihood of significant misclassifications. (Page M-22 & M-23)

94. Training of City staff and elected officials regarding their disclosure obligations under federal and state securities should be conducted no less frequently than every two years. (Pages 262 & M-13)

95. The CFO, in consultation with two newly created entities – the Auditor General and the Audit Committee, should assume oversight authority for an effective annual training program for the financial reporting staff who report to them. (Page M-2)

Response: City Management agrees with recommendations and will implement a coordinated approach for the training of City employees in financial matters. This will include, but not be limited to: the implementation of a revised management plan to address deficiencies related to employee training and will be a phased approach. This will begin with revised policies and procedures governing employee training programs and concluding with establishment of appropriations to fund programs and the monitoring of ongoing compliance with established policy. The training program will not only cover employees under the Chief Financial Officer, but those employees located out in departments that influence and impact the recording and reporting of financial transactions for the City. An aggressive training program **will be fully implemented until July 2007**.

In addition, staff has begun the process of providing educational information to the City Council and the first in a series of formal presentations to the Budget and Finance Committee on various elements of debt was provided in July 2006. **A second session will be presented to the Budget and Finance Committee regarding disclosure obligations before the end of calendar year 2006.**

96. Funding should be added to the budget to ensure adequate training of personnel to ensure that they remain current on financial reporting standards. (Pages 246 to 247)

Response: Agree. A budget amendment will be brought back to the City Council to add funding to the fiscal year 2007 to fund increased training to finance personnel.

Fiscal Impact

It is estimated that an additional annual appropriation of $500,000 will be needed to meet citywide training requirements in this area.

SDCERS FINANCIAL REPORTING

97. The Audit Committee concurs with actions being taken by the Retirement Administrator to establish a financial reporting function within SDCERS. (Page M-9)

Response: City Management agrees with this recommendation and will forward this to the SDCERS' Board for consideration.

SDCERS INTERNAL CONTROLS

98. SDCERS should develop a comprehensive methodology to identify, track, and recover overpayments made to deceased pensioners. (Page M-25)

Response: City Management agrees with this recommendation and will forward this to the SDCERS' Board for consideration.

SDCERS ACTUARIAL SERVICES

99. SDCERS should rebid 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. (Pages 260 & M-12)

Response: City Management agrees with this recommendation and will forward this to the SDCERS' Board for consideration.

SDCERS INVESTMENT ADVISORS

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 consultant. (Pages 258 & M-10)

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. (Pages 258 & M-10)

Response: City Management agrees with this recommendation and will forward this to the SDCERS' Board for consideration.

SDCERS FINANCIAL REPORTING

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. (Pages 257 & M-9)

Response: City Management agrees with this recommendation and will forward this to the SDCERS' Board for consideration.

CITY FUNDING OF SDCERS

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. (Pages 259 & M-11)

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. (Pages 259 & M-11)

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. (Pages 259 & M-11)

Response: City management agrees with these recommendations. For the past two fiscal years, the City has made its full annual requirement contribution. In addition, in fiscal year 2006, the City contributed an additional $107 million. As part of the overall fiscal recovery strategy and with the assistance of the City's actuary, steps will be taken to analyze an appropriate funding strategy to ensure that a timely repayment plan is put in place, while recognizing other fiscal priorities such as deferred maintenance, post employment medical costs, building adequate reserves, and funding critical remedial recommendations.

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. (Pages 259 & M-11)

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. (Pages 259 & M-11)

Response: City Management agrees. Certain aspects of this recommendation may require an amendment to the City's Municipal Code. Staff will work with the City Attorney to ensure that these changes are brought to the City Council for action **by December 2006**. SDCERS' tax consultant, Ice Miller LLP, which has been engaged since July 2004 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. SDCERS and the City are awaiting a final determination by the IRS. The City is awaiting the results of these discussions. The City believes that there could be an approximate $33 million liability that the City will need to repay to SDCERS.

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. (Page 260)

Response: City Management agrees. Staff is completing the City's first five-year forecast that will become an integral part of the City's short-term and long-term financial planning and budgeting. All costs, including projected ARC payments will be incorporated into the projections.

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. (Pages 261 & M-12)

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. (Page M-25)

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. (Page M-18, M-19 & M-20)

Response: City Management agrees that the amortization period for actuarial losses should be no longer than 15 years and that the amortization period for actuarial gain be no shorter than 5 years. These decisions are ultimately the sole discretion of the SDCERS' Board. The City can offer recommendations for SDCERS to consider and will do so at an upcoming SDCERS Board meeting when actuarial assumptions are discussed. Staff

will review the Pension Reform Committee's recommendations as part of its overall funding strategy as staff develops recommendations for dealing with the City's pension funding. This will be done in the context of the overall fiscal strategy for the City and will be incorporated into the City's five-year financial forecast.

SDCERS ORGANIZATIONAL STRUCTURE

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. (Page M-25)

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. (Page M-25)

Response: City Management agrees with this recommendation and will forward this to the SDCERS' Board for consideration.

SDCERS STAFF QUALIFICATIONS

114. The chief accounting officer of SDCERS should have adequate prior experience with investment operations and financial reporting and disclosures. (Pages 258 & M-10)

Response: City Management agrees with this recommendation and will forward this to the SDCERS' Board for consideration.

SDCERS BOARD STRUCTURE

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. (Pages 256 & M-8)

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). (Pages 256 & M-8)

117. The last two remaining positions shall be retired members, of the retirement system and selected in accordance with Charter Section 114(e). (Pages 256 & M-8)

Response: 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.

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. (Pages 256 & M-9)

Response: City Management agrees. Staff will begin developing an application which will seek all relevant and pertinent information regarding a Board Members qualifications and possible conflicts of interest. All persons seeking to fill a vacancy on the Board will be required to fill out this form. In addition, all current Board Members will be asked to complete this application form for the City's files. Any Board Member refusing to complete this application will be asked to step down from the Board.

119. SDCERS should have standing committees to address board governance, compensation and evaluation of the Retirement Administrator, investments, and an audit and compliance committee. (Pages 256 & M-9)

Response: City Management agrees with this recommendation and will forward this to the SDCERS' Board for consideration.

120. SDCERS should adopt a formal charter for each committee which should be updated no less frequent than every three years. Pages 257 & M-9)

Response: City Management agrees with this recommendation and will forward this to the SDCERS' Board for consideration.

121. SDCERS must be free to retain its own independent legal counsel. (Pages 260 & M-12)

Response: City Management agrees with this recommendation and will forward this to the SDCERS' Board for consideration.

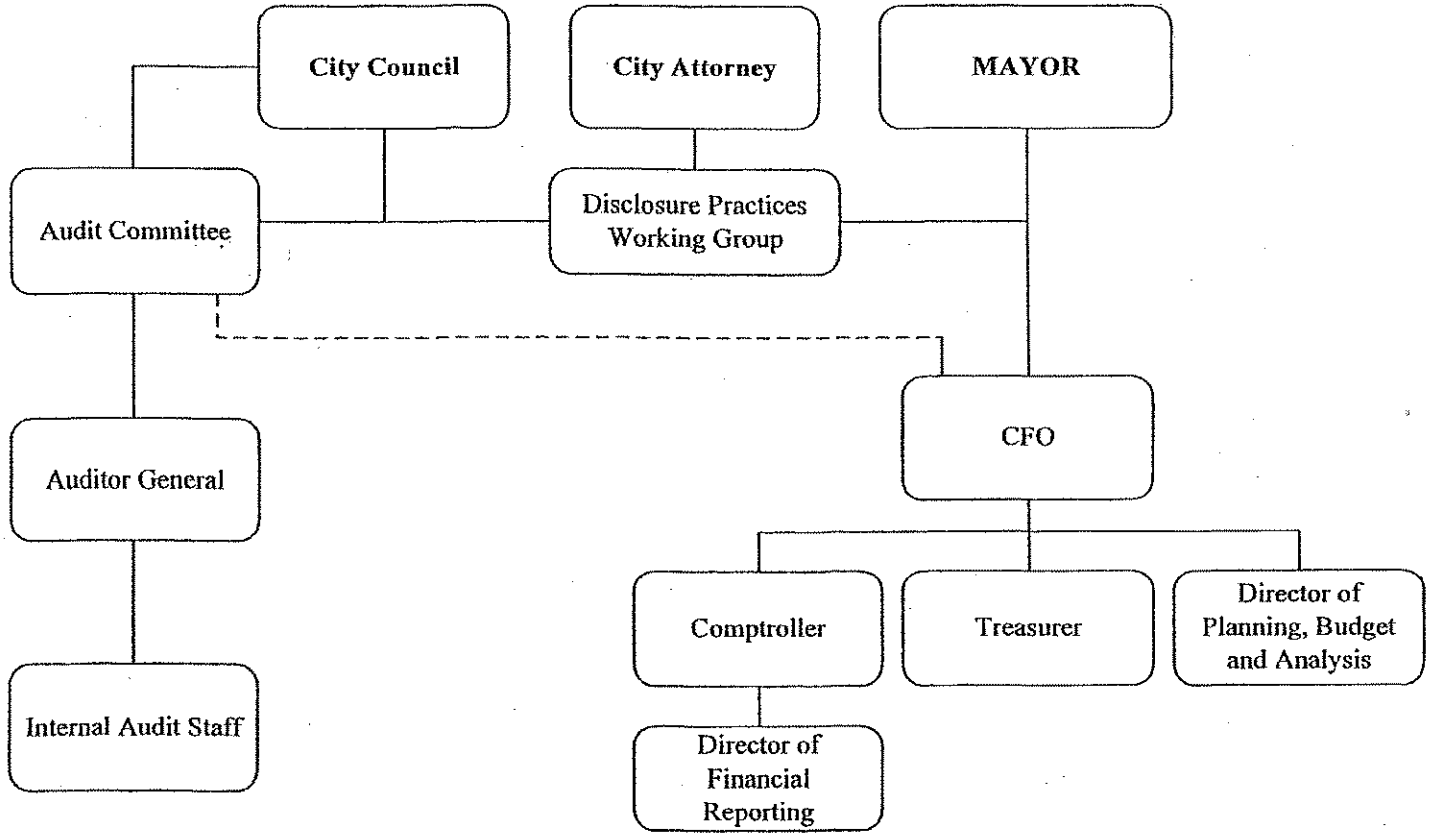
Fiscal Impact

There is no cost associated with implementing most of these recommendations; however, there is possible exposure on the part of the City in an amount of approximately $33 million (principal and interest through June 30, 2006) to repay SDCERS for the time when plan assets were used to pay for post employment medical benefit

Appendix N

Report of the Audit Committee of the City of San Diego

Proposed Financial Reporting Reorganization



NOTE: Support to the Audit Committee would be provided by the CFO and Auditor General and their Staffs.

OVERALL ESTIMATED FISCAL IMPACT

In summary, there are a number of remedial measures that the City will have to incorporate funding into the current fiscal year 2007 budget as well as future budgets. **The next schedule reflects the estimated annual cost through fiscal year 2013.** This time frame was selected because it will be staff's recommendation to finance the costs associated with a new Enterprise Resource Planning (ERP) software package (estimated to be $35 million principal plus interest) over a six year period. The accumulative estimated cost for all items is $44.9 million.

In addition to the above, staff recognizes there will be a need to repay SDCERS' for the past use of Plan assets to pay for post employment medical costs (currently estimated at $33 million). Discussion between the Internal Revenue Service and SDCERS suggest that the City may be able to spread this repayment over a five year period. The cumulative estimated cost of this would then be $41.3 million in addition to the estimated $44.9 million.

In addition to these remedial recommendations, there are several recommendations that City management concurs with but cannot estimate the cost at this time. These include:

1. Developing a comprehensive deferred maintenance list and providing adequate funding to address these needs within a reasonable timeframe.

2. Building the City's General Fund reserves to acceptable levels.

3. Accelerating the pay down of the City's Unfunded Actuarially Accrued Liability (UAAL), including the possible change to the timeframe for amortizing of actuarial gains and losses.

4. Implementing a reasonable schedule to fund the City's obligation for post employment medical benefits.

ESTIMATED COSTS RELATING TO THE IMPLEMENTATION OF CERTAIN REMEDIAL RECOMMENDATIONS

REMEDIAL RECOMMENDATION	Total Estimated Costs	Estimated Fiscal Year 2007	Estimated Fiscal Year 2008	Estimated Fiscal Year 2009	Estimated Fiscal Year 2010	Estimated Fiscal Year 2011	Estimated Fiscal Year 2012	Estimated Fiscal Year 2013
Formation of Audit Committee (item 18)	975,000	75,000	150,000	150,000	150,000	150,000	150,000	150,000
City Actuarial Services (items 22 &23)	580,000	300,000	20,000	20,000	100,000	20,000	20,000	100,000
Information Technology – Financial Reporting System (items 50 through 55)	35,460,000	0	5,910,000	5,910,000	5,910,000	5,910,000	5,910,000	5,910,000
Oversight Monitor (item 72)	4,000,000	1,000,000	1,250,000	1,250,000	500,000	0	0	0
Employee Compensation/Benefits (item 84)	390,000	390,000	0	0	0	0	0	0
Staff Training (item 96)	3,500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000
TOTAL ESTIMATED COSTS	**44,905,000**	**2,265,000**	**7,830,000**	**7,830,000**	**7,160,000**	**6,580,000**	**6,580,000**	**6,660,000**
SDCERS Funding (item 107)								
Accelerating the pay down of the City's Unfunded Actuarially Accrued Liability (UAAL)								
Tax Compliance for past retiree health (item 107)	41,325,315	0	8,265,063	8,265,063	8,265,063	8,265,063	8,265,063	0
Amortization schedule for current UAAL		To be determined	To be determined	To be determined	To be determined	To be determined	To be determined	To be determined
Amortization schedule for actuarial gains/losses		To be determined	To be determined	To be determined	To be determined	To be determined	To be determined	To be determined
Post Employeement Health Care		To be determined	To be determined	To be determined	To be determined	To be determined	To be determined	To be determined
Developing a comprehensive deferred maintenance list and providing adequate funding to address these needs within a reasonable timeframe.		To be determined	To be determined	To be determined	To be determined	To be determined	To be determined	To be determined
Building the City's General Fund reserves to acceptable levels.		To be determined	To be determined	To be determined	To be determined	To be determined	To be determined	To be determined

ATTACHMENT C

TIMELINE FOR IMPLEMENTATION

SEPTEMBER 2006

Recommendations 46 - 47	City's actuary to present first report.
Recommendation 48.ii.	Complete inventory of essential infrastructure assets.
Recommendations 1 - 6	Selection of Oversight Monitor complete.
Recommendations 84 - 86	Finalize consolidation of bank reconciliation process.

OCTOBER 2006

Recommendation 24	Establish policies and procedures to protect whistleblowers.
Recommendations 43 - 45	Present General Fund Reserve Policy to Council.
Recommendations 43 – 45	2007 Annual Budget published.
Recommendation 42	Amend Municipal Code to add criminal penalties for improper influence of public financial reporting process.
Recommendations 54 – 57	Present quarterly reports as well as budget to actual, fiscal-year-to-date comparison by department with explanation of variances to Council.
Recommendations 54 - 57	Present FY 2006 year end report on budget to Council.
Recommendation 87	Complete benchmark study of Police Compensation and health/welfare benefits for all employees.

NOVEMBER 2006

Recommendation 87	Complete benchmark study of Fire Compensation.

DECEMBER 2006

Recommendations 49 - 51	Amend Ordinance to redefine membership in the DWPG.
Recommendations 43 – 45, 66, 108 & 111	Finalize five year financial forecast and present to Council.

DECEMBER 2006 – cont.

Recommendation 73	Implement standard e-mail retention policy citywide.
Recommendation 83	Redevelopment Authority to complete upgrade of management processes.
Recommendations 106-107	Amend Municipal Code regarding the "Waterfall".

JANUARY 2007

Recommendations 67 - 71	Data warehousing and business intelligence project complete.

MARCH 2007

Recommendation 54 - 57	Complete Analysis of requirements to convert City financial accounting to monthly periods.

APRIL 2007

Recommendation 87	Complete Assessment of Public and Private Pension Systems.

MAY 2007

Recommendations 67 - 71	Select Enterprise Resource Planning (ERP) software.

JUNE 2007

Recommendation 73	Complete switch over to Microsoft Outlook and centrally managed messaging system.
Recommendations 75 - 77	Complete remediation of the internal control weaknesses identified in Auditor's Internal Control Report.
Recommendations 79 – 80	Develop and implement policies and procedures to reconcile period end accounts receivable.
Recommendation 83	Redevelopment Authority to complete upgrade of system and policies to track assets and liabilities.
Recommendation 89	Fully implement new procedures to better monitor Workers' Compensation cases.
Recommendation 120	SDCERS subcommittees to adopt formal charters.

JULY 2007

Recommendations 67 - 71	Implement ERP system.
Recommendation 90 - 95	Fully implement comprehensive training of City staff on financial matters.

AUGUST 2007

Recommendations 75 - 77	Present report on testing and remediation of internal controls.

SEPTEMBER 2007

Recommendation 48.i.	Facility Category Index of facilities and assets completed.

JANUARY 2008

Recommendation 48.iii.	Complete comprehensive assessment of deficiencies/deferred maintenance.
Recommendation 48.iv.	Complete development of preventive maintenance schedule and staffing requirements.

JUNE 2008

Recommendations 7 – 14, 25 – 29, 115 - 117	Charter changes regarding pension board composition and City organizational structure go to voters.

ATTACHMENT D

ANTICIPATED TIME TABLE FOR ACCESSING FINANCIAL MARKETS

The following represents staffs' current estimate of when the fiscal years 2003 through 2005 Comprehensive Annual Financial Reports (CAFRs) will be completed.

By October 27, 2006, KPMG will issue its opinion letter for the City's fiscal year 2003 CAFR.

By November 22, 2006, Macias Ginni & O'Connell will issue its opinion letter for the City's fiscal year 2004 CAFR.

By November 24, 2006, both the fiscal years 2003 and 2004 CAFRs will be distributed to all three rating agencies and discussions between the City and the rating agencies will begin.

By February 16, 2007, Macias Ginni & O'Connell will issue its opinion letter for the City's fiscal year 2005 CAFR.

By February 19, 2007, the fiscal year 2005 CAFR will be distributed to all three rating agencies and final discussions between the City and the rating agencies will occur.

By February 28, 2007, all three rating agencies will issue update ratings on the City.