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Jay M. Goldstone, CFO
Office of the Mayor
City of San Diego
202 "C" Street, 9th Floor
San Diego, California 92101

Dear Mr Goldstone:

Accompanying this letter are our reports concerning the results of the auditing procedures that our firm has applied to the accounting records of the Water and Sewer Funds of the City of San Diego. The purpose of this cover letter is to summarize the results of the auditing procedures performed.

AUDITING STANDARDS FOR AGREED UPON PROCEDURE ENGAGEMENTS

Auditing standards provide that reports for special purpose audit projects such as this be in the form of an agreed upon procedures report. Because of the unusual and highly focused nature of these engagements, auditing standards do not stipulate the scope of testing for agreed upon procedure engagements. Accordingly, a formal opinion is not expressed in an agreed upon procedures report. Alternatively, in agreed upon procedure reports, the procedures performed and the results of those procedures are spelled out so that readers can draw their own conclusions based upon the evidence disclosed by such engagements.

As with all audits, agreed upon procedure engagements are performed on a test basis in order to test the reliability of the systems and procedures utilized to account for financial transactions. Audit engagements do not typically involve the examination of every transaction because it would be cost prohibitive to do so. In order to maximize the effectiveness of this engagement, we designed our tests to be focused on the transactions of the Water and Sewer Funds that represented *significant dollar amounts* impacting those funds.

COST PRINCIPLES

Local governments such as the City of San Diego follow the accounting principles set forth for fund accounting. One of the basic principles of fund accounting is that the costs for activities that benefit more than one fund should be allocated to the other funds in proportion to the benefits received by the participating funds. This principle was applied in the performance of our testwork. This is in contrast to the erroneous viewpoint (not accepted by accounting standards) that only incremental (or marginal) increases in an activity's cost that was caused by other funds would be allocated to those funds.

INTERFUND TRANSFERS AND ALLOCATIONS

Our testing was applied to financial transactions of the year ended June 30, 2003. This year was selected because it represented a *recent* year (allowing complete accessibility to supporting documentation) that was viewed most likely to contain potentially questionable or aggressive accounting practices in consideration of other issues that have been raised with respect to that fiscal year. The scope of our testing would be expanded to additional fiscal years if significant problems were identified in the year subjected to our testing. The results of our testing did not warrant this expansion.

General Overhead Allocations (General Government Services Charge)

In a fund accounting system, general overhead allocations are used to assign to each fund a portion of the costs incurred by the departments of a City that provide a supporting function for other departments and funds of the City. Accounting standards provide guidelines with respect to these general overhead allocations. We found that the City's general overhead allocation system (the General Government Services Charge) conformed to these guidelines.

Service Level Agreements

In additional to the general service allocations provided by the General Government Services Charge, the City of San Diego uses other methods to assign costs to the funds that benefited from certain specific cost centers. One of those methods involved the use of Service Level Agreements. Service Level Agreements define the scope of work to be performed by one department of the City for other funds or departments of the City.

We focused our testing on the largest Service Level Agreements for the year ended June 30, 2003. As a result, we were able to account for in our testing an unusually high percentage of audit coverage. The Service Level Agreements represented in our testing accounted for over 50% of the dollar amounts charged to the Water and Sewer funds as a result of Service Level Agreements.

For these Service Level Agreements (SLA), we found that over 70% of the costs assigned under these agreements to the Water and Sewer Funds were supported by the time keeping system of the City, which tracks the specific activities performed by each employee on a daily basis. This documentation represents the recommended form of support for personnel costs. However, in view of community concerns surrounding SLA agreements, we recommended in our report that the City take the unusual step of augmenting this standard level of documentation with additional monthly reports from the servicing department that describe in detail the specific benefits received by the Water and Sewer Funds as a result of the servicing department's time keeping system charges for that month.

We found that in fiscal year 2002-03, the City Attorney's office instructed certain of its employees to charge the various funds of the City (including the Water and Sewer Funds) based on the *planned* utilization of City Attorney personnel that were made available to specified departments of the City, rather than the *actual* hours expended by those employees. This practice is **not** in conformity with generally accepted accounting principles. We found no evidence that this practice was followed by other departments of the City. The amounts in question associated with personnel of the City Attorney's office represent less than 1% of the total expenses of the Water and Sewer Funds. Our procedures indicate that this practice was substantially discontinued late in calendar year 2004.

We also tested the non-labor portion of SLA costs and found no significant unsupported or inappropriate charges.

Other Interfund Transfers Payments

In addition to the methods of cost allocation identified above, the City recorded other charges to the Water and Sewer Funds that represented transfers or payments to other funds of the City. We found that the amounts of these payments made by the Water and Sewer Funds were in proportion to the benefits received by the Water and Sewer funds, except for the following transactions that aggregate to less than 1% of the total expenses of the Water and Sewer Funds.

The following transfers recorded in the Water Fund included amounts disproportionate to the benefits received by the Water Fund:

- $280,000 Transfer to the General Fund for construction costs for the Kiddie Hall playground
- $238,475 Transfer to the General Fund for the Equal Opportunity Contracting Program
- $79,629 Transfer to the General Fund for the cost of lobbying contracts
- $35,085 Transfer to the Special Training Fund for reimbursement of the Career Development & Mentoring Program
- $11,017 Transfer to allocate certain costs of the Equal Employment Opportunity Program.

The following transfers recorded in the Sewer Fund included amounts disproportionate to the benefits received by the Sewer Fund:

- $254,302 Transfer to the General Fund for the Equal Opportunity Contracting Program.

- $87,353 Transfer to the General Fund for the cost of lobbying contracts.
- $73,407 transfer to the Special Training Fund for reimbursement of the Career Development & Mentoring Program.
- $13,630 Transfer to allocate certain costs of the Equal Employment Opportunity Program.

USE OF FUNDS GENERATED BY RATE INCREASES

We analyzed the uses to which the City applied certain recent rate increases for the Water and Sewer Funds. Our testing revealed that the funds generated by these rate increases were used to finance *capital project expenditures* of the Water and Sewer Funds and to pay for *increases in the operational expenditures* of the Water and Sewer Funds. Transfers to the General Fund and other funds of the City were funded by resources of the Water and Sewer Funds other than the City Council-approved rate increases.

USE OF BOND PROCEEDS

We also tested the Water and Sewer Funds for inappropriate use of bond proceeds. No ineligible projects were identified. Although all uses for bond proceeds were found to be in accordance with the specifications for the bond issue, for a small number of the bond-funded transactions (less than 1% of the total amount of bond-financed project expenditures), support for the transactions was not in strict accordance with standard documentation practices. Our report set forth recommendations for the City to amend its practices to provide documentation for the use of bond proceeds that conforms to a *best practices* level of documentation.

OVERALL SUMMARY

In summary, no significant improprieties were noted with respect to the accounting practices for the Water and Sewer Funds of the City. Unsupported uses of Water and Sewer Funds (including City Attorney charges based on *anticipated*, rather than *actual* use of personnel) were minimal (totaling to less than 1% of Water and Sewer Fund expenses). Where identifiable, inappropriate charges are being restored to the appropriate funds. We found no material departures from generally accepted accounting principles.

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If you have any questions regarding the foregoing or the accompanying detailed reports, please do not hesitate to give me a call.

Sincerely,

MAYER HOFFMAN MCCANN P.C.

Ken Al-Imam, C.P.A.
Shareholder