THE CITY OF SAN DIEGO

City of San Diego

SECOND ANNUAL REPORT ON INTERNAL CONTROLS

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1 *CAFR = Comprehensive Annual Financial Report (The City of San Diego's annual financial statements)*

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Executive Summary

City Ordinance 19320 was adopted by the City Council in October 2004, to achieve "a high standard of quality in and efficacy of the City's financial and disclosure practices", and requires the City Auditor & Comptroller (City Auditor) to perform an annual evaluation of the City's internal financial controls.

An entity's internal control structure is designed to provide reasonable assurance regarding the achievement of management's objectives, including the reliability of financial reporting. *An internal control structure is comprised of an organization's various control policies and procedures and the management environment within which those policies and procedures operate.*

The initial internal control report issued under Ordinance 19320 was dated January 1, 2006 and focused on control weaknesses posing the greatest risk of materially adverse impacts on the accurate and timely preparation of the City's annual financial statements. That report presented various remedial actions to correct the control weaknesses identified therein. The primary purpose of this second annual report is to evaluate the progress of the implementation of the major remediation measures presented in the January 2006 report.

Conclusions

Although much remains to be accomplished, progress was made in calendar year 2006 in implementing remedial actions. The City's internal controls over financial reporting, as of this report date, have improved to permit timely and accurate preparation of the City's annual financial statements.

Organizational Issues - It was previously determined that the organizational structure of the Auditor's office did not serve to promote accurate and efficient preparation of the City's annual financial statements. Reorganization of the Auditor's Office has served to address span of control issues, allocation of duties issues, and the fixing of accountability.

Business Processes - It was previously found that significant impediments to the accessibility of data, and a lack of automated processes resulted in many manually intensive processes prone to error. To address this problem, a new financial reporting system was installed as a temporary measure and a needs assessment initiated as a first step in implementing a comprehensive financial system.

> 'We conclude that the City's internal controls over financial reporting, as of this report date, have improved to permit timely and accurate preparation of the City's annual financial statements.'

Other Issues - Issues such as a lack of adequate training in the Auditor's office and throughout the organization, over-centralization of the accounting function, and potential auditor independence issues identified in our 2006 report have begun to be addressed.

Control Environment - In the 2006 Report, we pointed to what we perceived as a critical need for the City to work towards the creation and maintenance of a climate of honesty and openness that allows people to feel safe enough to discuss difficult issues. The new Mayor has embraced this issue and has encouraged staff on a regular basis to participate actively in this change in culture. This report reiterates that it is most important for the City's top officials to continue their stated commitment to build, strengthen and maintain a 'control environment' that not only tolerates, but in fact encourages contrary opinions.

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ANNUAL REPORT ON INTERNAL CONTROLS

I. Introduction:

A. Legislative Background

As stated in the prior year's report, City Ordinance 19320 (the Ordinance) was adopted by the San Diego City Council on October 11, 2004 to address deficiencies in the processes utilized by the City to disclose information to the financial markets. These disclosures include those made in the Comprehensive Annual Financial Report (CAFR), as well as in various Bond disclosure documents. According to the language of the Ordinance, the primary purpose and intent of the City Council in its enactment was to achieve "a high standard of quality in and efficacy of the City's financial reporting and disclosure practices."

To achieve the Council's purpose, the Ordinance differentiates between "disclosure procedures and controls" and "internal financial controls" and requires separate annual evaluations and reports be conducted for each of these control types.

This report pertains to the evaluation required by paragraph 22.0708 of the Ordinance – the internal financial controls established and maintained primarily by the Chief Executive (the Mayor) and the City Auditor & Comptroller (the Auditor). Reporting on disclosure procedures and controls is within the purview of the Disclosure Practices Working Group. Accordingly, disclosure controls are not directly addressed in this report, although numerous remediation measures presented in the 2006 report will serve to strengthen the integrity of the City's financial disclosures.

B. The Nature of Internal Controls

What are Internal Controls? - Internal controls are essentially a coordinated set of policies and procedures designed to provide reasonable assurance of achieving management's objectives. These objectives include the effectiveness and efficiency of operations as well as the reliability of financial reporting.

It is to achieve these objectives and meet its responsibilities that management establishes a framework of internal controls. The five elements of this framework are discussed individually in our prior Report on Internal Controls, dated January 2006 (available on the City of San Diego's Auditor & Comptroller website). Suffice it to say here, that in practice, to be effective, control policies and procedures *must operate within a management environment that is supportive of such controls.* The importance of a positive 'control environment' in any system of internal controls cannot be overemphasized and is addressed later in this report.

Administrative Controls vs. Financial Controls - Internal controls that are designed and implemented to assure or enhance the efficiency and effectiveness of operations are designated as '*administrative controls*'. Controls that are designed and implemented to assure accuracy and timeliness of financial reporting are designated as *'financial controls'*.

For the purposes of this report, this current annual review (as was our prior review) is limited to addressing those controls that impact the accuracy and timeliness of the City's financial reporting (i.e. financial controls). It is anticipated that as this annual internal control review process evolves, future reviews will opine on the adequacy of administrative controls – the controls that are or should be in place to assure the delivery of high quality services at the lowest cost in all phases of the City's operations.

Examples of Internal Control Policies and Procedures – By way of illustration, a typical internal control *policy* pertaining to purchase of supplies and equipment would consist of a requirement that purchases over a certain dollar amount be authorized by the purchasing manager.

The reason for such a policy would be to provide management with a reasonable level of assurance that a specific management objective would be achieved. In this case, the objective would be the acquisition of quality goods at the lowest price. The policy could require that certain formal bid requirements are followed, that purchases are made only from vendors who meet certain quality standards, etc.

A *procedure* for assuring that this policy is faithfully adhered to would typically include the use of pre-numbered purchase requisitions signed and approved by the appropriate department head and a written purchase order signed by the purchasing agent.

The development of automated business processes provides new and more efficient levels of opportunities to implement control procedures assuring faithful adherence to an organization's control policies.

The best control policies and procedures, however, will only be as effective as management will allow them to be. (See comments on 'Control Environment issues in the following paragraph).

"The best control policies and procedures, however, will only be as effective as management will allow them to be."

Importance of the 'Control Environment' - Internal controls do not operate in a vacuum. The best thought-out policies and the best-designed business processes and procedures can be rendered totally ineffective by so-called *'management override'*. The concept of management override was aptly demonstrated in this City's recent past and was attributed (in the Kroll Report) to a "prevailing culture of political expedience".[2] The most effective safeguard to management override is the establishment and maintenance of a positive control environment.

The 'control environment' is a term used to describe what is commonly referred to as the 'tone-at-the-top', or more broadly as the 'corporate culture'. The key element in a favorable control environment is management's attitude, as demonstrated through its actions and example. The City's management team includes elected officials, appointed officers, and senior executives. *The control environment is viewed as the most important of all internal controls, because the effectiveness of all the other controls depends upon it.*

C. Project Scope

In an effort to optimize the efficient use of extremely limited audit resources, the extent of our review for this calendar year was limited to revisiting our prior Annual Report on Internal Controls (January 2006) in order to evaluate the status of the ongoing implementation of remedial actions recommended in that report. Subsequent to the publication of the January 2006 Report, the Report of the Audit Committee of the City of San Diego was published (August 2006 - the "Kroll Report"). The Kroll Report referenced, as 'remediations', the recommendations contained in the prior Report on Internal Controls.

2 *Report of the Audit Committee of the City of San Diego, August 8, 2006, (p. 4)*

Last Year's Review - In performing our initial review of internal controls, we utilized a 'top-down, risk-based approach' as recommended by the Securities and Exchange Commission. We focused on those areas posing the greatest risk of having materially adverse impacts on the accurate and timely preparation of the City's CAFR. Accordingly, major emphasis was placed on reviewing the organization and business processes within the Auditor & Comptroller's office as they affect preparation of the City's CAFR.

Additionally, significant effort was placed on evaluating the City's control environment, considered throughout the authoritative literature, as pointed out above, as the most important element of an entity's internal control structure and the foundation for all other controls.

In our effort to evaluate the control environment for our 2006 Report, we conducted training sessions for approximately 190 City staff and senior management to acquaint them with basic control environment concepts, and to familiarize them with terminology that subsequently was utilized in several employee surveys regarding control environment issues.

Based upon the results of our efforts last year, we developed a series of recommendations (included in our January 2006 Report), the implementation of which we felt was critical if we were to be able to conclude positively as to the condition of the City's financial reporting controls for the current (January 2007) Report on Internal Controls.

This Year's Review - The scope of our current review of internal controls consisted primarily of a discussion of the status of the implementation of the recommendations in the January 2006 Report, the major impacts the identified internal control deficiencies had on our FY2003 CAFR beginning balances, and recommendations for future implementation.

II. Major Impacts of Control Deficiencies on FY2003 CAFR Beginning Balances

A. INTRODUCTION:

The various internal control deficiencies identified in the January 2006 Report on Internal Controls involved either non-existent or ineffective control policies and procedures, ineffective organizational design, and an organizational culture that had been intolerant of dissenting or alternative opinions.

Collectively, these deficiencies led to inaccuracies in the accounting for and reporting of the City's financial transactions and economic position. In total, mistakes in the FY2003 CAFR exceed $ 1 billion, necessitating major restatements to the CAFR as originally prepared.

To illustrate the impact of past internal control deficiencies on the accuracy of the FY2003 CAFR, an analysis of two major financial statement items are presented below. The nature of the errors are presented, including the internal control weakness that allowed the errors to occur, and the controls implemented to prevent reoccurrence of these mistakes in the future.

B. MAJOR RESTATEMENTS:

1. Restatement of Depreciation for Completed Capital Improvement Projects:

Background - Generally Accepted Accounting Principles (GAAP) require that capital assets (such as buildings, equipment, vehicles, etc.) be recorded on the 'books' at the cost of purchase or (as in the case of buildings) the cost to construct the asset. When capital assets are constructed, GAAP requires that the total cost to construct the asset be entered on the books and depreciation be recognized each year over the projected life of the asset *beginning with the year in which the project was completed.* For example, if a building cost $30 million to construct and has an estimated useful life of 30 years, upon completion, the annual depreciation recognized on the City's accounting records would be $1 million. This annual $1 million depreciation charge would be made each year over the 30 year life of the building (until the total depreciation of $30 million equaled the costs of construction).

The Problem - In our situation, because of internal control weaknesses (in this case, faulty procedures and misinterpretation of GAAP), the City did not begin recording depreciation expense for certain capital improvement projects at the time they were completed and placed into service, thereby understating depreciation expense and overstating the value of the City's assets by approximately $159 million, an amount most of which accumulated over several decades.

Why This Happened - The accurate calculation of annual depreciation charges depends, as a starting point, upon the availability of an accurate listing of all City-owned assets. Although several asset lists are maintained (one by the Auditor's office and others by the operating departments), no attempts had been made in the past to reconcile the data on the various lists for compatibility. In the absence of an accurate listing of all City-owned assets, the annual depreciation expense recorded in the CAFR was consequently incorrect.

The understatement of depreciation expense was exacerbated by a misinterpretation of the GAAP definition dealing with project completion. The concept of 'project completion' is critical because depreciation of assets under construction is not begun until the construction project is completed. Field personnel in the operating departments had not consistently reported completed projects to the Auditor's office. Projects/systems that had been 'placed into service' (i.e. components that were being used) were still considered incomplete by the operating departments in cases where minor work (such as landscaping) remained to be done. GAAP deems a project complete when it is 'placed into service' even though additional work may remain before the project is 100% complete.

In other instances, Project Managers sometimes failed to notify the Auditor's Office that projects were complete and placed in service. As a result, these completed projects were never placed on the books and depreciated. While the cost of the projects was being accumulated, the Auditor's Office failed to review the ledgers to note that construction in progress was not being 'completed' (e.g. certain projects may have been abandoned at some point prior to completion. Costs expended for these projects should have been 'written off' to reflect project abandonment).

Finally, we noted that no one individual in the Auditor's office was charged with overall responsibility for oversight of Capital Assets.

Remedial Action Taken - The Auditor's Office reorganization placed one individual in charge of all Capital Assets. This person is responsible for accounting for capital assets as well as performing reasonableness tests on the ledger to notice inconsistencies such as assets in a perpetual state of construction. Discrepancies in asset databases are discovered and corrected by periodic reconciliations on a timely basis.

In addition, staff accountants from the Auditor's office have attended professional training courses for capital asset accounting and many have been placed 'in the field' and are physically located in the various operating departments. The thought behind this move is the belief that the quality of the City's Capital Asset accounting will improve to the extent that the accountants become familiar with the 'business' of the operating departments and become attuned to the management philosophies and decision making processes of the departments for which they are responsible.

The ultimate solution to the existence of conflicting information on various asset listings is the procurement of a comprehensive capital asset system with a single universal database providing controlled access to City staff involved in the capital asset accounting process. A comprehensive 'needs assessment' of the City's financial system requirements, the first step in the procurement of such a system, has been initiated.

'The ultimate solution to the existence of conflicting information on various asset listings is the procurement of a comprehensive capital asset system with a single universal database...'

2. Restatement of Contributed Infrastructure:

Background - Often, to mitigate the effects of residential or commercial development, developers may be required to construct public facilities (parks, streets, ball fields and other infrastructure) that, upon project completion, are donated by the developer to the City. GAAP requires that these donated assets be added to the City's 'books', depreciated, and included on the City's annual financial statements.

The Problem - As part of its current review of the 2003 CAFR, we noted a failure to capitalize certain infrastructure assets that were contributed to the City by real estate developers. We then performed a comparison of assets on the City's Water and Sewer Geographical Information System (GIS) and the City's Fixed Asset Management Information System. The resulting reconciliation identified numerous assets that were not capitalized, the value of which was estimated using the cost of comparative infrastructure. The write-up (increase) of assets resulting from this adjustment was $249 million with the majority of adjustments dating from the 1980's and 1990's.

Why This Happened - This situation arose due to departments' lack of attention to the process of acceptance of developer contributions. Likewise, the Auditor's Office failed to inquire why, with the volume of development occurring in the City, the total for developer contributed assets was not increasing. Only when the departments began to survey infrastructure for their GIS System did they realize the problem. The lack of reconciliation between the departments' records and the Auditor's Office records exacerbated the situation.

Remedial Action Taken - To rectify the failure in controls, the Auditor's Office is performing periodic reconciliations between the asset record databases. However, a permanent fix will be to integrate the two systems, either by building an electronic interface or installing a new comprehensive accounting system.

Note: APPENDIX A to this Report includes a list and a discussion of each of the adjustments to the FY2003 CAFR Beginning Balances.

III. Follow-up on the January 2006 Internal Control Report

A. INTRODUCTION:

The 2006 Report on Internal Controls, for purposes of presentation, classified identified internal control deficiencies into the following categories:

- Control Environment
- Organizational Issues
- Business Practices
- Other Issues

The January 2006 Report's conclusions in each of the above categories may be summarized as follows:

> **Control Environment** - The Report noted a critical need for the City to work towards the creation and maintenance of a climate of honesty and openness that allows people to feel safe enough to discuss difficult issues. It was the conclusion of the January 2006 Report that deficiencies in the City's control environment constituted the primary, underlying causative factor facilitating the commission of the alleged fraudulent actions which resulted in the SEC inquiries, among other undesirable results.
>
> **Organizational Issues** - The Report found that the organizational structure of the Auditor's office did not serve to promote accurate and efficient preparation of the City's annual financial statements. Span of control issues and allocation of duties inhibited efficiency of operations and accountability for work performed.
>
> **Business Processes** - The Report indicated significant impediments to the accessibility of data, and a lack of automated processes resulted in many manually intensive processes prone to error.
>
> **Other Issues** - Issues such as a lack of adequate training in the Auditor's office and throughout the organization, over-centralization of the accounting function, and potential audit independence issues were also identified as areas in need of remedial action.

When the cumulative effect of individual internal control deficiencies were considered and placed within the context of the then prevailing control environment, the Report concluded that " as of the (January 2006) report date we are unable to conclude that the City's internal controls over financial reporting are adequate to assure timely and accurate reporting."[3]

The 2006 Report presented various recommendations to 'remediate' an obviously unacceptable situation. Upon its issuance, the Report and its recommendations were endorsed by the City of San Diego's Audit Committee, as was the necessity of the implementation of those recommendations.[4]

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3 *City of San Diego, Annual Report of Internal Controls, January 1, 2006*
4 *Electronic Letter from Lynn Turner, Kroll Inc., to the City Auditor & Comptroller, January 7, 2006*

B. CURRENT STATUS OF PRIOR RECOMMENDATIONS

Each of the internal control weaknesses identified in the 2006 Report is presented below (in the 'Finding' paragraphs) along with the current implementation status of each.

1. Control Environment Issues -

Finding: Although we found that various mechanisms were currently in place which are typically supportive of a positive control environment (an established Ethics Commission, campaign disclosure requirements, codes of conduct, etc), we found a general reluctance on the part of staff at all levels to engage in discussion of controversial issues.

Prior Recommendations:

(1) **Bi-annual, mandatory values-based ethics training** -

In the 2006 Internal Control Report we recommended that all management personnel and elected officials receive mandatory values-based ethics training and that new employees be required to read and certify to the City's written ethics policies on an annual basis.

(2) **Establishment of an Employee Hotline** -

We recommended that the City establish an employee 'hotline' to give staff at all levels a voice in those instances where issues of 'doing the right thing' may become obscured by the exigencies of operational or political expediency.

Implementation Status:

Because of the obvious criticality of the 'control environment issue', the Mayor has consistently emphasized this issue in citywide monthly management meetings, as well as in meetings with City staff.

In this regard, the Mayor has established an Office of Ethics and Integrity (OEI) tasking it as follows:

> "The Office of Ethics and Integrity's mission is to strengthen the City's Ethical Climate so that honor is cherished, personal integrity and ethical courage are the cultural norms and all employees are supported and encouraged to use their judgment and initiative in the conduct of ethical practices in the workplace.
>
> Through these practices, our workplace will become more customer service oriented; our workforce motivated and satisfied; and public trust will be restored."[5]

'The Office of Ethics and Integrity's mission is to strengthen the City's Ethical Climate...'

A significant benchmarking effort was undertaken by OEI during Fall 2006 consisting of an ethics survey which served to gauge (and confirm) attitudes towards the City's 'control environment' as perceived by City staff and management:

> "The survey results show that most City employees remain unsure about the City's ethical standards and about the process for reporting lapses and violations of the City's ethics policies and procedures. They also reveal that employees believe that the City's top managers are not held to the same ethical standard as other City workers and that employees are reluctant to report violations ethics or misconduct for fear of retribution."[6]

5 *Office of Ethics and Integrity Webpage, Mission Statement*
6 *Mayor Press Release/Fact Sheet, City's Employee Ethics Survey Reveals Need For Greater Education and Improved Reporting Process, December 7, 2006*

At the Mayor's direction, the City is prepared to move forward to address the concerns raised by employees. OEI is using the survey results to focus the design and development of **all** its initiatives - including training, educational materials, and support for employees - to ensure that all of the issues raised in the survey are fully addressed.

OEI has begun this effort with training for top management. Already, the City's executive leadership (the Mayor, Chief Operating Officer, Assistant COOs, Deputy Chiefs, Fire-Rescue Chief, Police Chief, and Personnel Director) have participated in two Executive Leadership Ethics Roundtable sessions facilitated by experts in government ethics from the Markkula Center for Applied Ethics.

Training for the City's Unclassified Managers will begin in early 2007, with sessions that will provide them with the tools they need to assist employees in reporting ethics concerns. Training for classified employees will begin in spring 2007 and will include a focus on ethical problem solving and decision-making in the real world. All employees, classified and unclassified, will also take compliance-based training on City and state ethics-related rules and regulations."[7]

The Auditor and Comptroller's Office implemented an employee hotline in December 2005. Subsequently, operational monitoring of the hotline was transferred to OEI. OEI coordinates hotline activities and a multi-departmental group including the City Auditor, the OEI Director, and Personnel Director, review all incoming complaints and the results of any investigations conducted.

2. Organizational Issues -

Findings:

(1) ***'Span of control' issues*** - We noted in our 2006 Report that the Operations Division in the Auditor's office was responsible for preparation of the City's CAFR. We pointed out that this division was responsible for a wide variety of citywide accounting operations and contained two-thirds of the Audit department's staff under the direction of one division manager. This extremely large span of control led, in our opinion, to an inevitable dilution in the quality and timeliness of management oversight of the CAFR process by the Operations Division manager. The manager was responsible for overseeing a myriad of day-to-day functions including accounting matters, cost allocation and budgetary reporting, as well as financial reporting and CAFR preparation.

(2) ***Allocation of Duties*** - Responsibilities for accounting functions and CAFR preparation were not confined to discrete groups. This, we observed, presented challenges in the coordination, communication, accountability and supervision problems throughout the department. We recognized that accounting duties were being handled by *fund* and not by *function* making it difficult for any one person to become proficient, much less expert, in the nuances of any one area or specialty of governmental accounting. Furthermore, no written criteria for utilizing the City's Chart of Accounts existed. This resulted in a lack of consistent treatment of accounting data among the City's various funds.

Prior Recommendation:

Prior to the publication of the 2006 Internal Control Report, the Auditor and Comptroller had developed a Departmental Reorganization Plan for the Auditor's office, which was presented to and approved by the City Council in August 2005. The plan recommended the establishment of a separate Financial Reporting Division within the Auditor's office responsible for preparing the CAFR and other interim reporting.

7 *Office of Ethics and Integrity Webpage*

In addition, the plan called for re-allocating various duties among Auditor and Comptroller operating Divisions to align responsibility and authority by functions so as to promote efficiency, improve the quality of work product, to enhance accountability and to facilitate training opportunities.

Implementation Status:

In accordance with the Auditor's Reorganization Plan, we established a new Financial Reporting Division whose focus is the preparation of the City's annual financial statements as well as to provide timely, accurate data to the Mayor, Council and department managers to enhance the decision making process at all levels.

The Department reorganized staff along functional lines by creating a reporting group, a debt group, a capital assets group, etc., thereby permitting enhanced accountability, specialization, and focused training opportunities in specific subject matter areas.

We've attempted to empower our managers by giving them the responsibility, as well as the authority, to solve issues within their areas. We expect our managers and supervisors to take ownership of the processes for which they are responsible.

Addressing the span of control and allocation of duties issues has allowed our managers to devote more effort to formalizing and documenting processes.

3. Business Processes -

Finding:

Business processes in place to identify, summarize, reconcile, and report pertinent financial data were not formalized or documented and generally did not contain necessary controls to adequately assure the accuracy of data in the City's CAFR or the efficacy and ease of access to management data. Significant impediments to the accessibility to data inherent in the City's financial accounting and reporting system, together with a general lack of automated processes, resulted in numerous manually intensive, tedious processes. The results included increased workloads, more opportunities for human error, which is inherent in all manual processes, and significant delays in meeting deadline dates.

Prior Recommendation:

The Auditor and Comptroller developed a Departmental Reorganization Plan for the Auditor's office, which was presented to, and approved by the City Council in August 2005. The plan recommended the continuing review and enhancement of processes to promote process effectiveness and to optimize the utilization of resources.

Implementation Status:

Due to a critical lack of staff resources coupled with significantly increased demands on those resources (primarily due to the fact that four CAFRs are being prepared concurrently), the review of the Auditor's internal business processes have been focused in several specific areas:

- Extensive documentation and re-engineering of the CAFR preparation process has been accomplished by the CAFR preparation team – a qualified, very capable group of accounting professionals comprised of Operations staff assisted by Internal Audit staff. Initial improvements to the CAFR preparation process are aimed at accelerating the preparation of future CAFRs, as well as reducing future audit fees by presenting information to the outside auditors in a more complete, better organized format.

- The implementation of a 'quasi real-time' financial reporting system that permits ready access (from any City personal computer) to a variety of financial data which has been updated on a daily basis. This data access, which was lacking prior to the implementation of this new system, will serve to significantly improve the preparation and audit of the 2006 and future CAFRs as well as facilitate preparation of reports for management decision-making and budget monitoring.
- Significant processing efficiencies have been implemented in the areas of Accounts Payable processing, automated mailing of vendor checks, and automated timecards for City employees.

4. Other Issues -

a. Finding:

Training - The lack of adequate training, while prevalent throughout the City organization was, we noted, particularly acute in the Auditor's professional staff. The lack of adequate professional training provided to the Auditor's staff over the last 10 years, contributed directly to the significant and substantial errors in the FY2003 CAFR beginning balances. The annual savings that had been realized by the elimination of training in the Auditor's office was more than offset by the millions of dollars expended in the efforts to correct those errors.

Prior Recommendation:

Training - The Auditor's office should provide training to professional and clerical staff on an ongoing basis. The City organization should annually assess the training needs of its personnel and provide adequate budget and discipline to ensure such training takes place.

Implementation Status:

Training - During FY 2006 continuing into FY 2007, the Auditor and Comptroller's Office has provided basic and advanced general and specific training to approximately one-half of its office staff. Training oversight for citywide staff has been consolidated in the office of the City's Chief Operating Officer.

b. Finding:

Centralized Accounting - We noted that the City's accounting function was centralized to a degree that isolated accounting staff from City departments for which they are responsible – both physically and operationally. As a result, risk existed that staff were either unaware that certain management actions had been taken (such as the abandonment of certain construction projects), or unaware of the logic (and therefore the financial impact) of those actions for accounting purposes.

Prior Recommendation:

Centralized Accounting - The Auditor's office should decentralize certain accounting functions by providing operating departments with qualified accounting staff. We believe that the quality of the City's accounting should improve to the extent that the accountants are familiar with the 'business' and the management decision-making processes of the departments for which they are responsible.

Implementation Status:

Centralized Accounting - Accounting staff formerly residing in the Auditor's office have been physically relocated to various field locations (Metropolitan Wastewater Department, Water Department, SDCERS, etc). This has served to enhance communications between the Auditor's office and the operating departments as well as improving the accuracy and timeliness of data received from those departments.

c. Finding:

Internal Auditor Independence - The professional literature emphasizes that an entity's internal control structure is only as effective as the foundation upon which it is built. That foundation is, in essence, the entity's control environment. As such, extreme care must be taken by top management not only to establish a positive control environment, but also to assure that *continuous oversight* is provided to assure the continued effectiveness of the control environment in actual practice. In this regard, the literature points out that an entity's internal audit function serves as a 'super-control' since the Internal Auditor, as the guardian of the internal controls, is tasked with the ongoing monitoring of the effectiveness of the organization's control structure.

Prior Recommendation:

Internal Auditor Independence - In order to effectively oversee the City's 'control environment, it is imperative that the auditor be situated within the organization in such a way as to foster the internal auditor's independence. Most significantly, the Internal Auditor should not report to the entity's CEO under any circumstances. This concept is recognized in the California Government Code Section 1236, the Recommended Practices of the Government Finance Officers Association, and the internal auditing standards promulgated by the Institute of Internal Auditors.

> '...it is imperative that the Internal Auditor be situated within the organization in such a way as to foster independence. Most significantly, the Internal Auditor should not report to the entity's CEO...'

Implementation Status:

Auditor Independence - On December 6, 2006 the City Council established an Audit Committee consisting of three Council Members and in early 2007 will determine its nature and staffing. The 'checks and balances' inherent in this audit committee structure is an essential first step toward embedding Auditor independence in the organization. It follows that it is critical that the Audit Committee establish a governing Charter that will promote a truly independent audit function within the City organization. Separation of the 'Auditor' functions from the 'Comptroller' functions, a logical next step, will require a vote of the people, which will likely take place in 2008.

d. Finding:

Accessibility of Financial Data - Significant impediments to the accessibility of data inherent in the City's financial accounting and reporting system, together with a general lack of automated processes, resulted in numerous manually intensive, tedious processes, prone to error.

Prior Recommendation:

Accessibility of Financial Data - The Auditor's office should continue its process of fully implementing the Simpler Financial System that had been partially implemented at the time of last year's Internal Control Report.

Implementation Status:

Accessibility of Financial Data - The Simpler Financial Reporting System was successfully implemented last year providing all departments access to accurate actual and budget data on a timely basis. The next step in the Auditor and Comptroller's plan was to install a financial statement preparation system enabling the Auditor and Comptroller Department to prepare combining statements, which are currently being done manually. Such a system would have helped the Auditor and Comptroller's Department prepare timely financial statements for the CAFR. However, development on such a system has been halted so that the City can concentrate on developing a citywide enterprise resource planning (ERP) System, which will include a comprehensive financial system. The Auditor's office supports this strategy.

Kroll Report:

In August 2006, Kroll Inc., acting as the City's Audit Committee, issued its report entitled, *"Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure."* Included therein were most of the internal control deficiencies noted in our prior Report on Internal Controls, dated January 2006, as well as other control weaknesses.

The Kroll Report included numerous, specific 'remediations' detailing actions Kroll believed the City needed to implement in order to restore a positive control environment and a sound internal control structure to the City organization.

The Mayor and City Council have conceptually adopted the Report's remediations and the Mayor's office has developed a comprehensive Remediation Plan detailing specific action that needs to be taken along with timelines for completion of each element of the implementation. The City has engaged a professionally credentialed project manager (a Certified Public Accountant), to oversee the timely and successful implementation of each remedial action.

IV. Auditor's Conclusions

Control Policies and Procedures -

The internal control deficiencies identified in the January 2006 Report on Internal Controls focused on non-existent or ineffective control policies and procedures, ineffective organizational design, and an organizational culture that had been intolerant of dissenting or alternative opinions. To some extent these internal control deficiencies continue although significant strides have been made to identify the components of those deficiencies and an overarching approach has been out in place to deal with the City's remediation efforts.

'... any internal control structure can be rendered ineffective because even the best control policies and procedures are susceptible to 'management override'.'

The Auditor's reorganization has facilitated the improvement of internal lines of communication, accountability and operational effectiveness – all of which will have had a positive impact on current and future financial statement preparation. However, the office continues to be hampered by the continued existence of numerous manual processes necessitated by the lack of a technologically modern general ledger system. In addition, the continuing effort expended on concurrently finalizing four outstanding CAFRs has consumed a significant expenditure of resources that otherwise could be devoted to improving the Department's business processes.

Throughout the City's departments, Business Process Reengineering efforts have served to streamline operations and improve administrative controls, all of which will have a positive effect on financial reporting by improving the accuracy and timeliness of data transmitted to the Auditor's office.

Control Environment Issues –

It should be noted that any internal control structure can be rendered ineffective because even the best control policies and procedures are susceptible to 'management override'. As pointed out above, the Mayor has emphasized the importance of this issue and is committed to establishing, nurturing and maintaining a positive control environment. This effort needs to be relentless and ongoing. The results of the recent OEI survey discussed earlier in this Report documents the fact that top management's verbal commitment to a non-oppressive environment does not automatically filter down through the management and staff ranks. At least in the short-term, City employees will remain skeptical and unconvinced.

As a result, it is most important, from the standpoint of restoring and maintaining a sound internal control structure, for the City's top officials to continue their stated commitment to build, strengthen and maintain a 'control environment' – a 'tone at the top' of the organization that not only tolerates, but in fact encourages contrary opinions while fostering the open and honest discussion of contentious issues.

This commitment needs to be matched by actions supportive of that commitment. The consequences of doing otherwise under the guise of the organization's short-term benefit, has served to cause severe long-term damage to the City's financial structure and reputation. Perpetuation of a control environment that would permit a repeat performance is not acceptable.

'...it is most important... for the City's top officials to continue their stated commitment to build, strengthen and maintain a 'control environment'... that not only tolerates, but in fact encourages contrary opinions...'

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V.

CERTIFICATION BY CHIEF FINANCIAL OFFICER AND AUDITOR & COMPTROLLER

In accordance with the requirements of paragraph 22.0708 of San Diego City Ordinance 19320, the Mayor and the Auditor & Comptroller hereby certify that they:

(1) are responsible for establishing and maintaining the City's internal financial controls;

(2) have identified the need to design such internal financial controls to ensure that material information relating to the City and its departments, offices, agencies, and affiliated 'related entities' as defined in San Diego Municipal Code Section 22.1702, is made known to the Mayor and/or the City Auditor & Comptroller by others within the City and its departments, offices, agencies, and affiliated 'related agencies', particularly during the period in which the Annual Report required by this section is being prepared;

(3) have presented in the Annual Report their conclusions about the effectiveness of the internal controls based on such evaluation as of that date;

(4) have evaluated the effectiveness of the City's internal financial controls as of a date within 90 days prior to the Annual Report;

(5) have disclosed all significant deficiencies in the design or operation of internal controls that could adversely affect the City's ability to record, process, summarize, and report financial data;

(6) have identified for the City's independent auditors any material weaknesses in internal controls and any fraud, whether or not material, that involves management or other employees who have a significant role in the City's internal controls;

(7) the City Auditor in coordination with the Mayor's Office has conducted an annual evaluation of the City's internal financial controls as reported in the document titled "Annual Report on Internal Controls," dated January 1, 2007, and that such report accurately identifies the results and conclusions of that evaluation.

SIGNED: _____
John Torell, CPA
City Auditor & Comptroller

SIGNED: _____
Jay M. Goldstone
Chief Financial Officer

DATE: 12/28/06

DATE: 12/28/06

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APPENDIX A

SECOND ANNUAL REPORT ON INTERNAL CONTROLS

January 1, 2007

Summary of Restatements to the FY2003 CAFR

As of Draft 13 (December 29, 2006)

General Restatements

1. The City overstated its allowance for bad debt because a previous year's allowance total had not been reversed. In the government-wide financial statements and the fund level financial statements for the sewer utility fund, the resulting adjustment was an increase in accounts receivable and an increase in net assets for business-type activities of $1,218.

2. Certain bond issuance costs were incorrectly expensed and not deferred at the fund level for the sewer utility fund and for governmental fund debt in the government-wide financial statements. The resulting adjustment was an increase in net assets for governmental and business-type activities of $13,922 and $1,417, respectively. In the fund level financial statements, the resulting adjustment was an increase in deferred charges and net assets of $1,417 for the sewer utility fund.

3. The City did not record an accrual for energy costs in its financial statements for water utility and sewer utility. In the Government-wide financial statements, the resulting adjustment was an increase in accounts payable and a decrease in net assets for business-type activities of $312. In the fund level financial statements, the resulting adjustment was an increase in accounts payable and a decrease in net assets for the following funds: $232 in the sewer utility fund and $80 in the water utility fund.

4. The City incorrectly recorded payments to defease the Horton Plaza 1996 B Tax Allocation Bond as a purchase of investments. Interest earned on escrowed funds and debt service was also recorded erroneously. The effect of this error was to overstate cash and investments and interest earnings since fiscal year 2000. The correction of this error in the government-wide financial statements resulted in a decrease of net assets of $6,640. In the fund level financial statements, the resulting adjustment was a decrease in cash and investments and a decrease in fund balance for other governmental funds of $6,974.

5. The City incorrectly recorded the assets of a defined contribution plan for the Centre City Development Corporation (CCDC) as fiduciary fund assets even though the City did not hold these assets in a trustee or agency capacity for CCDC. In both the statement of fiduciary net assets – pension and employee savings trust and the fiduciary fund level financial statements, the resulting adjustment decreased pension trust fund net assets by $5,180.

6. The City incorrectly recorded billings to participating agencies of the City's sewer utility as deferred revenue. In the government-wide financial statements, the resulting adjustment was a decrease in deferred revenue and an increase in net assets for business-type activities of $9,470. In the fund level financial statements, the resulting adjustment was a decrease in deferred revenue and an increase in net assets for the sewer utility fund of $9,470.

7. The City, in error, classified San Diego Data Processing Corporation (SDDPC) as an enterprise fund instead of an internal service fund. When SDDPC was created, the intent was for them to operate as an information services provider to both the City as well as other governmental entities in the region. However, over time the City has become the primary customer providing the majority of SDDPC's revenues. As such, it should have been classified as an internal service fund/blended component unit of the City. Now that it is an internal service fund it is subject to the internal service allocation pursuant to GASB 34. In the government-wide financial statements, the resulting change was a decrease in net assets for governmental activities of $10,293 and an increase in net assets for business-type activities of $10,293. In the fund level financial statements, the resulting adjustment was an overall increase in net assets for other enterprise funds of $4,435 and a decrease in net assets for internal service funds of $4,435.

8. The City incorrectly recorded investments being held with a custodian for the San Diego Housing Commission (SDHC), a discretely presented component unit, as an asset of other governmental funds. In the government-wide financial statements, the resulting adjustment was a decrease in Cash & Investments and net assets for governmental activities of $198. In the fund level financial statements, the resulting adjustment was a decrease in Cash & Investments and fund balance for other governmental funds of $198.

9. The City incorrectly recorded interfund transfers as working capital advances, giving the perception that the City funds would be repaid. These transfers represented all purchases and replacements of City vehicles made through the City's Central Garage/Equipment Division. In the government-wide financial statements, the resulting adjustment was an increase in net assets for governmental activities of $44,767 and a decrease in net assets for business-type activities of $44,767. In the fund level financial statements, the adjustment resulted in the following changes: a decrease in the general fund's fund balance of $10,728; a decrease in other governmental funds' fund balance of $11,898; a decrease in sewer utility fund net assets of $18,916; a decrease in water utility fund net assets of $15,533; a decrease in other enterprise fund net assets of $10,171; and an increase in internal service fund net assets of $67,246.

10. During the construction of the PETCO ballpark, the City incorrectly recorded the San Diego Padres' cash contribution in the Ballpark as the City's cash and investments. In the government-wide financial statements, the resulting adjustment was a decrease in cash and investments and a decrease in net assets for governmental activities of $48,648. In the fund level financial statements, the resulting adjustment was a decrease in cash and investments and a decrease in fund balance for other governmental funds of $48,648.

11. The City did not reverse accruals for grant receivables for the City's sewer utility fund. As a result, revenues were recorded twice when grant reimbursements were received. In the government-wide financial statements, the resulting adjustment was a decrease in grants receivable and a decrease in net assets for business-type activities of $6,602. In the fund level financial statements, the resulting adjustment was a decrease in grants receivable and a decrease in net assets for the sewer utility fund of $6,602.

12. The City incorrectly recorded grant receipts that should have been deferred revenue. In the government-wide financial statements, the resulting adjustment was a decrease in net assets for governmental activities of $1,540. In the fund level financial statements, the resulting adjustment was a decrease in fund balance for other governmental funds of $1,540.

13. The City did not recognize portions of its deferred revenue balances as revenue when recognition criteria were met. In the government-wide financial statements, the resulting adjustment was a decrease in deferred revenue and an increase in net assets for governmental activities of $35,007, and an increase in net assets for business-type activities of $4,048. In the fund level financial statements, the resulting adjustment was a decrease in deferred revenue and an increase in net assets for the sewer utility fund of $4,048.

14. The City did not record the sale of a Land Held for Resale asset. In the government-wide financial statements, the resulting adjustment was a decrease in net assets for governmental activities of $29,876. At the fund level financial statements, the resulting adjustment was a decrease in fund balance for other governmental funds of $29,876.

15. The City incorrectly classified various properties as Land Held for Resale that should have been classified as Land, Easements, Rights of Way. In the government-wide financial statements, the resulting adjustment was a decrease in net assets for governmental activities of $6,141 (Capital Asset Restatement 8 contains an offset to increase net assets). In the fund level financial statements, the resulting adjustment was a decrease in fund balance for other governmental funds of $6,141.

16. The City incorrectly classified various properties as Land, Easements, Rights of Way that should have been classified as Land Held for Resale (a current asset). Part of this adjustment includes $5,824 which resulted from improperly reclassifying an asset (the error was to remove the asset from Land, Easements, Rights of Way while not simultaneously adding it to Land Held for Resale). In the government-wide financial statements, the resulting adjustment was an increase in net assets for governmental activities of $12,308 (The net effect of the $12,308 less the erroneous reclassification of $5,824 applies to Capital Asset Restatement 8, which contains an offsetting decrease to net assets of $6,484). In the fund level financial statements, the resulting adjustment was an increase in fund balance for other governmental funds of $12,308.

17. The City incorrectly capitalized expenditures as Land Held for Resale instead of as a capital project expenditure. In the government-wide financial statements, the resulting adjustment was a decrease in net assets for governmental activities of $100. In the fund level financial statements, the resulting adjustment was a decrease in fund balance for other governmental funds of $100.

18. The City did not capitalize expenditures for Land Held for Resale, but expended as capital projects instead. In the government-wide financial statements, the resulting adjustment was an increase in Invested in Capital Assets, net of Related Debt for Governmental Activities of $512. In the fund level financial statements, the resulting adjustment was an increase in fund balance for other governmental funds of $512.

19. The City did not recognize impairment on the net realizable value of land held for resale. In the government-wide financial statements, the resulting adjustment was a decrease in net assets for governmental activities of $11,034. In the fund level financial statements, the resulting adjustment was a decrease in fund balance for other governmental funds of $11,034.

20. The City, on behalf of SDCERS, incorrectly accounted for contracts entered into with employees for purchase of service credits. Specifically, the City and SDCERS did not record a receivable for the contract; however, interest on installment contracts had been included, and an allowance for doubtful accounts was created which reduced the receivable. In the fund level financial statements, the net impact was an increase in net assets for fiduciary funds of $670.

21. The City incorrectly recorded a working capital advance receivable as deferred revenue in the financial statements of the Redevelopment Agency. In the government-wide financial statements, the resulting adjustment was a decrease in deferred revenue and an increase in net assets for governmental activities of $84. In the fund level financial statements, the resulting adjustment was an increase in fund balance for other governmental funds of $84.

22. The City incorrectly carried investments of the Public Facilities Financing Authority (PFFA), a blended component unit. The asset represents an investment held with an escrow agent, solely to facilitate a refunding of several special assessment bonds. In the government-wide financial statements, the resulting adjustment was a decrease in net assets for governmental activities of $34,661. In the fund level financial statements, the resulting adjustment was a decrease in net assets for other governmental funds of $34,661.

23. The City incorrectly recorded grant receivables as revenue that should have been deferred because they were not collected within 60 days pursuant to the City's availability criteria (see Note 1 Sec. c). This was the result of recognizing grant revenues solely when grant eligibility requirements were being met. The resulting adjustment was a decrease in fund balance for other governmental funds of $19,363.

24. The City incorrectly omitted an investment trust fund representing cash owned and interest earned by legally separate entities (ARJIS, SanGIS and AVA) that held cash in the City Treasurer's investment pool. The resulting adjustment was an increase in net assets for fiduciary funds of $12,433.

25. The City incorrectly reported SDMSE as a discretely presented component unit. In accordance with GASB 14, it now has been changed to a joint venture arrangement. The City's equity share in the SDMSE joint venture is reported as such within the general fund as Reserved for Minority Interest in Joint Venture. The resulting adjustment is an increase in net assets for governmental activities and an increase in fund balance for the general fund of $1,137.

26. Related to Capital Assets Restatement 10, the City incorrectly accounted for an interfund loan between the water utility fund and the general fund. As a result, an interfund receivable was not recorded for business-type activities, and an interfund interest payable was not recorded for governmental activities. In the government-wide financial statements, the resulting adjustment was an increase in net assets for business-type activities of $2,734 and a decrease in net assets for governmental activities of $1,407. In the fund level financial statements, the resulting adjustment was an increase in interfund payables and a decrease in total fund equity for other governmental funds of $1,407; and an increase in interfund receivables and an increase in net assets for the water utility fund of $2,734.

27. Related to Capital Assets Restatement 13, accounts payable was also adjusted to reflect the accrual of the FBA Credits outstanding. In the government-wide financial statements, the resulting adjustment was an increase in accounts payable of $38,108 and a decrease in Unrestricted-Net Asset for the governmental activities of $38,108.

28. Related to Capital Assets Restatement 14, accounts payable was also adjusted to reflect the accrual of the retention amount. In the government-wide financial statements, the resulting adjustment was an increase in accounts payable of $3,550 and a decrease in Unrestricted-Net Assets for governmental activities of $3,550; and an increase in accounts payable of $9,132 and a decrease in Unrestricted-Net Asset for business-type activities of $9,132. In the fund level financial statements, the resulting adjustment was an increase in accounts payable and a decrease in Unrestricted-Net Assets for the following funds: $6,177 in the sewer utility fund; $2,931 in the water utility fund; and $24 in the other enterprise funds.

29. In November 1998 the Redevelopment Agency (Agency) entered into a Memorandum of Understanding with the Padres, and other entities, in which the Padres and Agency agreed to a land conveyance of various land parcels within the downtown ballpark area. The Padres agreed to advance funds to the Agency so that the Agency could buy land parcels (possibly through eminent domain) which would then be conveyed back to the Padres once certain legal requirements were met for development of the land by the Padres. From 1999 through 6/30/2002 the Padres had advanced a total of $27,050 to the Agency, the Agency then used these monies to buy various parcels around the Ballpark area. However, these funds represented a future liability to the Agency, a commitment to convey these land parcels to the Padres. This liability was never booked in the governmental activities, the resulting adjustment was a decrease in Unrestricted-Net Assets for governmental activities of $27,050.

30. The City overstated its interest accrued on long-term debt because of the incorrect payment date used for the calculation. In the government-wide financial statements and the fund level financial statements for the water utility fund, the resulting adjustment was a decrease in interest accrued on long-term debt and an increase in net assets for business-type activities of $804.

31. The City had not capitalized issuance costs for the PFFA - Ballpark debt in the amount of $2,044. In the government-wide financial statements, the resulting adjustment was an increase in deferred charges and an increase in Invested in Capital Assets, net of Related Debt for governmental activities of $2,044.

Capital Assets Restatements

1. The City had land assets recorded at incorrect carrying values as a result of not capitalizing land additions and improvements. In the government-wide financial statements, the resulting adjustment was an increase in Land, Easements, Rights of Way assets and an increase in Invested in Capital Assets, net of Related Debt for business-type activities of $12,354. In the fund level financial statements, the resulting adjustment was an increase in Capital Assets-net and an increase in Invested in Capital Assets, net of Related Debt for the following funds: $2,494 in the sewer utility fund and $9,860 in the water utility fund.

2. The City did not begin recording depreciation expense for certain capital improvement projects at the time they were placed into service. Timing differences in capitalization dates and "in service" dates, along with a failure to timely remove assets from construction in progress and place them into a depreciable asset classification, resulted in improper matching of depreciation expense and incorrect carrying values of assets. In the government-wide financial statements, the resulting adjustment for governmental activities was an increase in Accumulated Depreciation for Structures and Improvements of $5,652 and Infrastructure of $6,059; and in business-type activities was an increase in Accumulated Depreciation for Structures and Improvements of $51,779 and Equipment of $79,927 and Distribution and Collection Systems of $15,654. This resulted in a total decrease to Invested in Capital Assets, net of Related Debt for governmental activities of $11,711 and for business-type activities of $147,360. In the fund level financial statements, the resulting adjustment was a decrease in Capital Assets-net and a decrease in Invested in Capital Assets, net of Related Debt for the following funds: $107,308 in the sewer utility fund; $16,299 in the water utility fund; and $23,753 in the other enterprise funds.

3. During the City's implementation of GASB 34, the City capitalized certain infrastructure projects that were also incorrectly included as part of the City's Construction in Progress, resulting in an overstatement of non-depreciable capital assets. In the government-wide financial statements, the resulting adjustment was a decrease in Construction in Progress and a decrease in Invested in Capital Assets, net of Related Debt for governmental activities of $147,164.

4. Depreciation expense from prior years was recorded in error for distribution and collection system assets in business-type activities due to incorrect book values and estimates of useful lives. In the government-wide financial statements, the resulting adjustment was a decrease in Accumulated Depreciation for Distribution and Collection Systems and an increase in Invested in Capital Assets, net of Related Debt for business-type activities of $39,138. In the fund level financial statements, the resulting adjustment was an increase in Capital Assets-net and an increase in Invested in Capital Assets, net of Related Debt for the following funds: $33,334 in the sewer utility fund and $5,804 in the water utility fund.

5. The City recorded parcels of land designated as "open space" twice. In the government-wide financial statements, the resulting adjustment was a decrease in Land, Easements, Rights of Way assets and a decrease in Invested in Capital Assets, net of Related Debt in governmental activities of $15,828.

6. The City did not expense certain planning, pre-design, and preliminary costs when related capital projects were later canceled or abandoned. This resulted in an overstatement of capital assets. In the government-wide financial statements, the resulting adjustment was a decrease in Construction in Progress and a decrease in Invested in Capital Assets, net of Related Debt for governmental activities of $45,188; and a decrease in Construction in Progress and a decrease in Invested in Capital Assets, net of Related Debt for the business-type activities of $126,566. In the fund level financial statements, the resulting adjustment was a decrease in Capital Assets-net and a decrease in Invested in Capital Assets, net of Related Debt for the following funds: $85,475 in the sewer utility fund; $39,425 in the water utility fund; and $1,666 in the other enterprise funds.

7. The City incorrectly capitalized leasehold improvements to Balboa Park which were made by the Zoological Society of San Diego. In the government-wide financial statements, the resulting adjustment was a decrease to Construction in Progress assets of $10,805, Structures and Improvements of $147,879, Equipment of $45,873 and a decrease in Accumulated Depreciation for Structures and Improvements of $71,563 and Equipment of $27,256, and a decrease in Invested in Capital Assets, net of Related Debt for governmental activities of $105,738.

8. The City did not capitalize several land parcels owned by the Redevelopment Agency at the correct value. In the government-wide financial statements, the adjustment resulted in a net increase to Land, Easements, Rights of Way assets of $6,633. The $6,633 is the net effect of an increase of $6,141 (Capital Asset additions from General Restatement 15), $6,976 (Capital Asset additions solely attributable to Capital Assets Restatement 8), less the $6,484 (which is the portion of capital asset reductions from General Restatement 16) that is attributable to this restatement. Part of this adjustment also included increases in Structures and Improvements of $8,107 and Accumulated Depreciation for Structures and Improvements of $203 for a total increase in Invested in Capital Assets, net of Related Debt for governmental activities of $14,537.

9. The City identified that it did not capitalize certain infrastructure assets that were contributed to the City by real estate developers. As a result, the City performed a reconciliation between the City's Water and Sewer Geographical Information System and the City's Fixed Asset Management Information System. The resulting reconciliation identified numerous assets that were not capitalized, of which the value was estimated using the cost of comparative infrastructure. In the government-wide financial statements, the resulting adjustment was an increase in Distribution and Collection Systems of $255,770 and an increase in Accumulated Depreciation for Distribution and Collection Systems of $6,734 for a total increase in Invested in Capital Assets, net of Related Debt for business-type activities of $249,036. In the fund level financial statements, the resulting adjustment was an increase in Capital Assets-net and an increase in Invested in Capital Assets, net of Related Debt for the following funds: $108,175 in the sewer utility fund and $140,861 in the water utility fund.

10. A parcel of land that the water utility fund financed for the general fund was incorrectly capitalized as an asset of the water utility fund. In the government-wide financial statements, the resulting adjustment was a decrease in Land, Easements, Rights of Way assets and a decrease in Invested in Capital Assets, net of Related Debt for business-type activities of $1,227. In the fund level financial statements, the resulting adjustment was a decrease in Capital Assets-net and a decrease in Invested in Capital Assets, net of Related Debt for the Water Utility Fund of $1,227.

11. The City expensed in error all costs associated with the new Main Library. It has since been determined that the library will be constructed and as such the amounts expensed have been reinstated into Construction in Progress. In the government-wide financial statements, the resulting adjustment was an increase in Construction in Progress and an increase in Invested in Capital Assets, net of Related Debt for governmental activities of $3,952.

12. The City incorrectly omitted two parcels of land which were not reported as non-depreciable capital assets. In the government-wide financial statements, the resulting adjustment was an increase in Land, Easements, Rights of Way assets and an increase in Invested in Capital Assets, net of Related Debt for governmental activities of $2,454.

13. The City incorrectly accounted for Facilities Benefit Assessment (FBA) Credit Agreements, which are reimbursement agreements entered into by the City and participating developers. The agreements allow for construction of specific infrastructure capital assets by developers that are identified in various Public Facilities Financing Plans. The assets are then conveyed to the City for credits that the developer can use in lieu of paying building permit fees. As a result, capital assets were recorded only when the developer used its credits by pulling permit fees. Upon review, it was determined that the amounts of unused credits earned by developers understated capital assets, liabilities, and net assets. The resulting adjustment was to fully record the value of the capital asset at the time of conveyance and a liability in the form of a payable for unused credits with the net as an increase to net assets. The payable is reduced at the time a developer uses a credit. In the government-wide financial statements, the resulting adjustment was a decrease in Construction in Progress of $2,437, an increase in Infrastructure of $51,080 and an increase in Accumulated Depreciation for Infrastructure of $712, and an increase in Invested in Capital Assets, net of Related Debt for governmental activities of $47,931.

14. The City did not capitalize the retention amount for its construction contracts when the invoices were being paid. In the government-wide financial statements, the resulting adjustment was an increase in Construction in Progress of $3,462, Structure and Improvements of $13, Infrastructure of $75, and an increase in Invested in Capital Assets, net of Related Debt for governmental activities of $3,550; and increases in Construction in Progress of $3,798, Structure and Improvements of $2,686, Distribution and Collection Systems of $2,648 and increases in Invested in Capital Assets, net of Related Debt for business-type activities of $9,132. In the fund level financial statements, the resulting adjustment was an increase in Capital Assets-net and an increase in Capital Assets, net of Related Debt for the following funds: $6,177 in the sewer utility fund; $2,931 in the water utility fund; and $24 in the other enterprise funds.

15. The City determined during its review of capital improvement projects that the San Pasqual Treatment plant, taken out of service in fiscal year 2002, was being considered for another use and therefore should have been considered as impaired. During discussions it was determined the impairment existed on the buildings as they were out of use, but would be needed for the future project in a different capacity. The equipment and infrastructure associated with the original plant are still in use for other purposes and are included in the Capital Assets Restatement #18 (see below). In the government-wide financial statements, the resulting adjustment was an decrease in Construction in Progress of $14,788, and increases to Structure and Improvements of $14,788, and Accumulated Depreciation for Structure and Improvements of $2,350, and a decrease in Invested in Capital Assets, net of Related Debt for business-type activities of $2,350. In the fund level financial statements, the resulting adjustment was a decrease in Capital Assets-net and in Invested in Capital Assets, net of Related Debt for the following funds: $1,191 in the sewer utility fund and $1,159 in the water utility fund. The current carrying value of the impaired structures is $12,438. See Capital Assets Note 4, for further discussion of the impairment.

16. The City, during further review of the sewer utility funds Construction in Progress projects, determined that three project management projects contained expenditures that needed to be expensed since the end projects associated with the expenditures did not result in a capital asset. In the government-wide financial statements, the resulting adjustment was an increase in Construction in Progress of $384, Equipment of $2,178, Distribution and Collection Systems of $2,439, and an increase in Accumulated Depreciation for Equipment of $679 and Distribution and Collection Systems of $396; and a decrease in Structures and Improvements of $10,720, and a decrease in Accumulated Depreciation for Structures and Improvements of $1,627; and a decrease in Invested in Capital Assets, net of Related Debt for business-type activities of $5,167. In the fund level financial statements, the resulting adjustment was a decrease in Capital Assets-net and a decrease in Invested in Capital Assets, net of Related Debt for sewer utility fund of $5,167.

17. The City identified two interfund land transfers in Land, Easements, Rights of Way, which were incorrectly recorded at the purchase price at the date of transfer rather than the City's original historical cost, thus misstating land. One land asset transferred from the water utility to the general fund overstating land $918. The other land asset transferred from the general fund to the sewer utility, water utility, and other enterprise funds overstating land $302 in the proprietary funds. Additionally, due to failing to recognize a gain at the time of acquiring the property an adjustment was necessary in the general fund of $1,027 to correctly record the purchase price. In the government-wide financial statements, the resulting adjustment was an increase in Land, Easements, Rights of Way assets of $109 ($1,027-918) for governmental-type activities and a decrease of $302 for business-type activities. In the fund level financial statements, the resulting adjustment was a decrease in Capital Assets-net and a decrease in Invested in Capital Assets, net of Related Debt for the following funds: $208 in the sewer utility fund; $208 in the other enterprise funds and an increase in Capital Assets-net and Invested in Capital Assets, net of Related Debt of $114 in the water fund.

18. The City identified capital improvement projects substantially completed prior to fiscal year 2003, which were incorrectly reported in Construction in Progress. Projects identified as substantially complete were transferred to the appropriate capital asset category. The resulting adjustment is an increase in the government-wide financial statements to Land, Easements, Rights of Way of $145, Structures and Improvements of $57,160, Infrastructure of $75,644, and a decrease of $132,949 to Construction in Progress for governmental activities (the net effect on governmental net assets, therefore, is zero). The resulting adjustment for business-type activities is an increase in the government-wide financial statements to Land, Easements, Rights of Way of $10,701, Structures and Improvements of $545,732, Equipment of $180,256, Distributions & Collections of $624,182, and a decrease of $1,360,871 to Construction in Progress (the net effect on business-type net assets, therefore, is zero). In the fund level financial statements, the resulting correction had no effect on Capital Assets-net or Invested in Capital Assets, net of Related Debt for either the sewer utility, water utility, and other enterprise funds.

19. The City previously classified San Diego Data Processing Corporation (SDDPC) as an enterprise fund instead of an internal service fund (see General Restatement #7 for further discussion). The resulting capital asset reclassification is an increase in the government-wide financial statements to Land, Easements, Rights of Way of $1,988, Structures and Improvements of $6,389, Equipment of $67,084 and related accumulated depreciation for Structures and Improvements of $7,296, and Equipment of $47,830, and Invested in Capital Assets, net of Related Debt for governmental activities of $20,335. The corresponding adjustment for business-type activities is the inverse of the adjustments to governmental activities listed above. In the fund level financial statements, the resulting reclassification was an overall decrease in net assets for other enterprise funds of $20,335 and an increase in net assets for internal service funds of $20,335.

20. The City did not capitalize interest expense as it related to projects undergoing construction, as is required per SFAS 34 and 62. In the government-wide financial statements, the resulting adjustment was an increase in Structures and Improvements of $42,490, an increase in Distribution and Collection Systems of $119,473, an increase in Construction in Progress of $3,945, an increase in accumulated depreciation for Structures and Improvements of $3,750, an increase in accumulated depreciation for Distribution and Collection Systems of $7,290, and an increase in Invested in Capital Assets, net of Related Debt for business-type activities of $154,868. In the fund level financial statements, the resulting adjustment was an increase in Capital Assets-net and in Invested in Capital Assets, net of Related Debt for the following funds: $137,998 in the sewer utility fund and $16,870 in the water utility fund.

Long-Term Liabilities Restatements

1. The City recorded public liability claims liabilities solely in its government-wide financial statements and not in its self insurance internal service fund, a proprietary fund servicing governmental activities. This resulted in an overstatement of internal service fund net assets. In the fund level financial statements, the resulting adjustment was a decrease in net assets for internal service funds of $55,461.

2. Certain bond discounts, premiums, and accretions were not being amortized over the debt period. In the government-wide financial statements, the amortization of these bond discounts, premiums and accretions resulted in a decrease in net assets for governmental activities of $3,054.

3. The City incorrectly credited payments for retiree health costs to its Actuarially Required Contribution (ARC) for retiree pension costs. Additionally, per assumptions adopted by the Board of the San Diego City Employees Retirement System (SDCERS), the Actuary did not recognize costs related to legal settlements relating to pension benefits (Corbett settlement) as part of the SDCERS Unfunded Accrued Actuarial Liability (UAAL). As a result, the City's ARC for the periods subsequent to the settlement was understated. The effect of this settlement was to increase the ARC retroactively and therefore increase the City's Net Pension Obligation (NPO). In the government-wide financial statements, the resulting adjustment was an increase in the City's NPO, a decrease in governmental activities net assets of $74,515, and a decrease in business-type activities net assets of $15,867. In the fund level financial statements, the resulting adjustment was an increase in NPO and a decrease in net assets for the following funds: $5,321 in the sewer utility fund; $4,391 in the water utility fund; $4,992 in the other enterprise funds; $2,777 in the internal service funds; and $319 in the fiduciary funds.

4. The City incorrectly recorded loans from SANDAG, a regional transportation agency, as revenue. In the government-wide financial statements, the resulting adjustment was an increase in SANDAG loans payable and a decrease in net assets for governmental activities of $18,805.

5. The City agreed to pay a portion of the employees share of pension costs, subsequently the City did not make a payment into SDCERS for the agreed upon amounts, nor did the City recognize a liability for amounts owed on behalf of employees. In the government-wide financial statements, the resulting adjustment was an increase in NPO and a decrease in net assets for governmental activities of $1,081 and a decrease in net assets for business-type activities of $230. In the fund level financial statements, the resulting adjustment was an increase in NPO and a decrease in net assets for the following funds: $77 in the sewer utility fund; $63 in the water utility fund; $72 in the other enterprise funds; $42 in the internal service funds; and $6 in the fiduciary funds.

6. The City did not record the defeasance of a loan payable. In the government-wide financial statements, the resulting adjustment was an increase in net assets for governmental activities of $3,250.

7. The City did not record a loan payable. In the government-wide financial statements, the resulting adjustment was a decrease in net assets for governmental activities of $1,876.

8. The City did not record an increase to a Contract Payable. In the government-wide financial statements, the resulting adjustment was a decrease in net assets for governmental activities of $117.

9. In relation to General Restatement 4, the City did not record the defeasance of the Horton Plaza 1996B Tax Allocation bond. In the government-wide financial statements, the resulting adjustment was a decrease in Tax Allocation Bonds Payable and an increase in net assets for governmental activities of $6,640.

10. The City did not include add-on pay and all employer taxes in its calculation of liabilities for accrued wages and benefits. Additionally, the City did not accrue for the wages and benefits earned during the portion of the last pay period of the fiscal year that fell in the fiscal year being reported. These errors resulted in an understatement of the City's accrued wages and benefits liability. In the government-wide financial statements, the resulting adjustment was an increase in accrued wages and benefits and a decrease in net assets for governmental activities of $4,887 and a decrease in net assets for business-type activities of $1,151. In the fund level financial statements, the resulting adjustment was an increase in accrued wages and benefits and a decrease in net assets for the following funds: $402 in the sewer utility fund; $316 in the water utility fund; $362 in the other enterprise funds; and $208 in the internal service funds.

11. The City previously classified San Diego Data Processing Corporation (SDDPC) as an enterprise fund instead of an internal service fund (see General Restatement #7 for further discussion). In the government-wide financial statements, the resulting adjustment was an increase in bank line of credit and a decrease in net asset for governmental activities of $3,944. The corresponding adjustment for business-type activities is the inverse of the adjustments to governmental activities listed above. In the fund level financial statements, the resulting adjustment was an overall increase in net assets for other enterprise funds of $3,944 and a decrease in net assets for internal service funds of $3,944.

12. The City did not record arbitrage liability. In the government-wide financial statements, the resulting adjustment was a decrease in net assets for business-type activities of $2,657. In the fund level financial statements, the resulting adjustment was an increase in arbitrage liability and a decrease in net assets for the following funds: $13 in the sewer utility fund and $2,644 in the water utility fund.

13. It was determined that the City's DROP obligation should be shown as liabilities and not as part of Net Assets, as they could be defined as due and payable in accordance with the plan terms, per GASB 25. This adjustment resulted in the creation of a new liability account titled DROP liabilities and a corresponding decrease to Fiduciary Net Assets of $97,430.

Discretely Presented Component Units Restatements

		Discretely Presented Component Units	
		San Diego Convention Center Corporation	San Diego Housing Commission
	Net Assets as of June 30, 2002, as stated	$ 11,546	$ 188,139
1	Change in Capitalization Threshold	-	(134)
2	Transfer of Restricted Cash for Facility Restoration Fund	117	-
3	Overstatement of Operating Revenues	-	(113)
4	Reclassification of a Grant to a Loan	-	512
5	Reclassification of a Grant to a Loan	-	(4,554)
6	Reclassification of Deferred Revenue	616	-
	Total Net Assets as of June 30, 2002, as restated	$ 12,279	$ 183,850

1. A change in the capitalization threshold for the San Diego Housing Commission (SDHC) resulted in a decrease in net assets of $134.

2. San Diego Convention Center Corporation (SDCCC) identified a transfer of restricted cash for the facility restoration fund, which resulted in an increase to net assets of $117.

3. SDHC identified an overstatement of operating revenues, which resulted in a decrease to net assets of $113.

4. SDHC reclassified a grant to a loan, which resulted in an increase to net assets of $512.

5. SDHC erroneously classified a zero payment, zero interest loan from the State of California as contributed capital versus a loan. The correction resulted in a prior period adjustment reducing net assets by $4,554.

6. SDCCC erroneously deferred revenue in fiscal year 2002 instead of recognizing those revenues when earned, the resulting adjustment was an increase to beginning net assets.

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