

# Annual Report on Internal Financial Control

**Calendar Year 2015**

Office of the City Comptroller

March 1, 2016



## Executive Summary

This Annual Report on Internal Control is issued pursuant to City of San Diego Municipal Code (SDMC) §22.0706, adopted by the City Council in October 2004 via Ordinance 19320, to achieve a high standard of quality in and efficacy of the City's financial reporting and disclosure practices. SDMC §22.0706 requires that management:

1. Perform an annual evaluation of the City's internal financial control;
2. Submit a written Annual Report to the Audit Committee and the City Council on management's annual evaluation of the City's internal financial control;
3. Submit a Certification by City Management regarding the design, maintenance, and effectiveness of the City's internal financial control.

Within the last 90 days, management evaluated the City's internal financial control. Based on this evaluation, it is management's conclusion that the internal financial control over the preparation of its Comprehensive Annual Financial Report (CAFR) is effective. We did not identify any significant deficiencies in the design or operation of internal control that could adversely affect the City's ability to record, process, summarize and report financial data. There were no significant changes in internal control, or in other factors, that could significantly affect internal control subsequent to the date of our evaluation.

Further supporting management's conclusion is the fact that no material adjustments and no material weaknesses or significant deficiencies in internal control over financial reporting were identified through the fiscal year 2015 CAFR independent audit. Additionally, the City received a Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association (GFOA) for the fiscal year 2014 CAFR.

Management assesses and monitors the effectiveness of internal financial control on a continuous basis. Through this effort, management is able to identify areas that may require additional controls to ensure the reliability of the financial information and compliance with accounting standards. Management's current focus, as it relates to internal control over accounting and financial reporting activities of the City, is the formal documentation of existing policies and procedures and related controls. This effort will increase accountability, reduce risk related to employee turnover and improve communication and monitoring efforts. The list below identifies the most significant internal control improvements for the assessment period.

### Internal Control Improvements – January 2015 – February 2016

- In fiscal year 2015, the Comptroller's Office documented 118 processes, exceeding its annual goal of documenting 100 processes each year. The Comptroller's Office is on track to meet its fiscal year 2016 goal of documenting an additional 100 processes.
- Documented accounting policy on classification of fund balance for governmental funds and created a decision tool to ensure accounting staff applies policy consistently.

- Developed financial statement preparation checklist for use by accountants and supervisors when preparing and reviewing fund level financial statements.
- Expanded accounts receivable analysis for a more complete review of potential accrual of revenue collected after the end of the fiscal year.
- Obtained third party confirmation for low-and-moderate-income housing fund loans and notes receivable.
- Documented Cost Allocation Process and implemented citywide training program.
- Revised and documented petty cash reimbursement process incorporating additional controls.
- Fully documented process for preparation of the Schedule of Expenditures from Federal Awards (Single Audit).
- Fully documented processes related to accounts payable function within the Comptroller's Office.
- Improved monitoring activities over payroll time entry and approval process.
- Launched a communication effort regarding roles and responsibilities for payroll time entry and approval through citywide communication, payroll specialist meetings and unclassified staff meetings.
- Worked with process owners to revise processes and related controls identified for changes during the 2014 assessment.
- Developed various financial reporting tools using business objects software that allow users to perform ad hoc queries and efficiently access financial data stored in SAP. These reports have been validated by the finance branch, facilitating the use of accurate and reliable financial data citywide. The following reporting tools were published by the finance branch:
  - Budget vs. Actual Report
  - Vendor Payments Transaction Report
  - Labor Detail Report
  - Capital Improvement Projects Financial Report
  - Comprehensive CIP Project Analysis Report
  - CIP Activity Summary Report
  - Encumbrance Listing
  - Online Analytical Processing Tool – Financial Management Module
  - Online Analytical Processing Tool – General Ledger Module
  - Accounts Receivable Invoice Details Report

## Background

The City is accountable to San Diego residents and outside stakeholders for the management of the City's financial and economic resources. It meets this responsibility by preparing its Comprehensive Annual Financial Report (CAFR) each year. The CAFR is the most significant financial report produced by the City for external users. It is available on the City's website and the investor information webpage and can be accessed by residents, investors, rating agencies and other interested parties. The CAFR is a comprehensive financial document that includes the balances and activity of all funds and component units of the City and related disclosures. The report typically takes five months to prepare and involves the work of more than 50 accountants in the Comptroller's Office, as well as key department staff who provide necessary information for required disclosures. The CAFR is prepared in accordance with Generally Accepted Accounting Principles (GAAP), which are established by the Governmental Accounting Standards Board (GASB). The CAFR is audited annually by an independent auditing firm who expresses an opinion on whether or not the basic financial statements are fairly presented in all material respects in accordance with GAAP.

Internal control over financial reporting is defined as a process established by an entity's governing body, management and other personnel, which has been designed and implemented to provide reasonable assurance regarding the achievement of financial reporting objectives. The main internal control objective in preparing the CAFR is that the information included in the report will be reliable and that it reflect the City's transactions and events for the reporting period in accordance with GAAP.

The most authoritative guidance on internal control over financial reporting is the integrated framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The City's internal control program is based on this framework.

The framework put forth by COSO is comprised of five fundamental components which, when present and functioning together, work towards the goals of reducing risk to an acceptable level, and achieving objectives for reliable financial reporting. These five fundamental components include (1) Control Environment, (2) Risk Assessment, (3) Control Activities, (4) Monitoring, and (5) Information and Communication. Our assessment on internal control over the preparation of the CAFR focused on an evaluation of each of these five components.

## Control Environment

The Control Environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The Control Environment sets the tone of the organization and represents what is commonly referred to in the private sector as an entity's "corporate culture." It encompasses the City's integrity and ethical values; the City Council and Mayor's oversight, responsibilities, and delegation of authority; the process for attracting, developing and retaining employees; and the measures, incentives and rewards used to manage accountability and performance.

The City has established policies and practices that provide for a strong control environment. The City's auditing function is overseen by an independent audit committee, which includes members from the public who possess the appropriate technical expertise. In addition, independent departments assist the City Council in establishing checks and balances over the executive branch, including the Independent Budget Analyst and the Office of the City Auditor. The Office of the City Auditor manages the contract of the independent auditing firm that is responsible for auditing the City's CAFR.

The City has established the Disclosures Practices Working Group (DPWG), a group responsible for ensuring compliance by the City with federal and state securities laws, and for promoting the highest standards of accuracy in disclosures relating to securities issued by the City or by its related entities. The SDMC requires that an evaluation and report be prepared by the DPWG on a yearly basis. In addition, the City has established mandatory securities law training for members of management, relevant City staff and elected officials.

The Ethics Commission contributes towards a strong control environment for the City. As an independent department, the Ethics Commission monitors, administers and enforces the City's governmental ethics laws, conducts investigations, refers violations to appropriate enforcement agencies, reviews disclosure statements and advises and educates City officials, candidates, political committees, and lobbyists about governmental ethics laws.

Continuing education for professional staff who have financial responsibilities is critical for maintaining the City's achievements in delivering comprehensive and accurate financial information to the City's stakeholders. The City's Chief Financial Officer requires financial professionals to grow and maintain their professional competencies in all areas of accounting, reporting, compliance, grant analysis, ethics, and any other finance related field. This is accomplished through training policies that have been tailored for each department to promote competencies in their respective area. The Comptroller's Office training policy requires that staff engaged in accounting, financial reporting, and payroll functions participate in a minimum of 40 hours of formal subject matter training per year. This ensures that accounting staff responsible for preparation of the CAFR are knowledgeable of the accounting standards relevant to their area of responsibility.

Other practices and policies contributing to a strong control environment for the City include the adoption of an Employee Code of Conduct, the Fraud, Waste and Abuse Hotline, and the Annual Report on Internal Financial Control.

## **Risk Assessment**

A continuous and effective assessment of risk is a critical component of the internal control framework because it allows management to form a basis for determining how risk should be managed and mitigated. It allows management to identify the need for control and monitoring activities, improvements to the flow of information and communication or the need for changes to the control environment.

COSO defines “risk” as the possibility that an event will occur and adversely affect the achievement of objectives. As noted earlier, the main objective in preparing the CAFR is that the information included in the report will be reliable and that it reflect the City’s transactions and events for the reporting period in accordance with GAAP. The policies and procedures established to prepare the CAFR include controls that have resulted from management’s risk assessment and its efforts to mitigate such risks.

At the beginning of each CAFR preparation cycle, management communicates areas of potential risk to the City’s independent auditor based on management’s risk assessment and ongoing monitoring activities, including management’s response to such risks through development and implementation of additional controls. For the fiscal year 2015 reporting cycle, the Comptroller’s Office identified the following risks and the related controls applied during the reporting cycle:

Risk	Control Activities	
1	Risk that a City department may enter a Goods Receipts document in SAP for items that have not actually been received, generating erroneous expenditure accrual transactions	Review by Comptroller’s Office for all good receipts transactions recorded in the system above a certain materiality threshold
2	Risk that an accountant misclassifies fund balance within fund balance categories when preparing financial statements. Fund balance classification is a manual process that relies on the judgement and technical knowledge of the accountant preparing the financial statement	Supervisory and Management review; year-over-year variance analysis; development of clear classification policies; development of decision tools consistently used by staff to apply categorization policy
3	Risk that a City department may misclassify a fixed asset or may not timely communicate the addition of donated assets or disposition of fixed assets.	Biennial department inventories; asset account monitoring; documented fixed asset process narratives; formalized capitalization and project close out procedures requiring formal communication; regular routine inquiries by the Comptroller’s Office.
4	Risk of misstatements during Implementation of GASB No. 68 regarding pension accounting. GASB No. 68 significantly changed disclosure and accounting requirements for defined benefit pension plans	Reliance on authoritative guidance, consultation with external auditors and peer organizations; supervisory and management review; pension accounting training.
5	Risk that the notes and loans receivables related to low-mod housing fund (Successor Housing Entity) are not properly valued and or that they are still in existence	Obtaining third party confirmation from debtors to ensure there is agreement on the receivable balance reported in the City’s CAFR

Much of the recent work performed by the Comptroller's Office, as it relates to internal control, has focused on formally documenting policies and procedures related to accounting and financial reporting. Most of these policies and procedures have been long-standing practice and consistently applied each fiscal year. However, unwritten policies and procedures introduce risk when there is turnover in personnel, and can reduce accountability. The Comptroller's Office has identified approximately 760 processes that require documentation, of which approximately 319 have been formally documented and approximately 441 have not. Process documentation is a critical component of the Comptroller's Office strategic plan and one of its key performance indicators. We anticipate having fully documented all significant financial processes for the office within the next three fiscal years.

## Control Activities

Control activities are the next logical step in response to risks identified through management's risk assessment. COSO defines *control activities* as the actions established through policies and procedures that help ensure that management's directives to mitigate risks are carried out. In the CAFR preparation process, these are the policies and procedures, with embedded controls, that management develops and implements to ensure that risks to preparing reliable financial reporting are addressed.

### Transaction Control Activities

The implementation of the Enterprise Resource Planning System (SAP) was a defining event in the City's progress towards a well-designed internal control framework. SAP allows internal controls to be embedded in the system through restricted access, segregation of duties and authorization workflows. These controls allow for review, validation and approval of transactions, not only mitigating the risk of fraud but also preventing transaction errors or instances of non-compliance with laws and regulations.

In a typical month, there are in excess of 14 million user interactions within SAP. The majority of these interactions occur in various departments as they perform their core responsibilities. Often, transaction workflows cross departments in order to properly segregate duties and mitigate the risk of fraud. For example, the Comptroller's Office processes employee payroll, but only the Personnel Department can change an employee's hourly rate in SAP. Other transactions include vendor payments, generation of City invoices, cash deposits, payroll transactions, journal entries, most of which segregate the creator of the transaction from the approver. These interactions make their way into the financial system either through direct input or through some type of interface application. The City's financial activity is consolidated with similar types of activities and is eventually presented in the CAFR.

Over the years, the City has implemented a variety of control activities over financial transactions. Where automated controls are not available, manual control are used. These control activities ensure that the financial information is complete, accurate and valid. Below are some of the control activities embedded in the City's multiple accounting and financial reporting processes:

- Authorizations and approvals that affirm that a transaction is valid, such as the approval of a journal entry or an invoice payment;
- Verifications- comparing two or more items with each other, such as comparing goods received against a purchase order;
- Physical controls, such as comparing fixed asset inventories against control records;
- Reconciliations – comparing two data elements and taking action when differences are identified to bring the data into agreement, such as reconciling bank accounts to the general ledger; and
- Supervisory controls that assess whether other transaction control activities are being performed completely, accurately and in accordance with policy.

### **Control Activities deployed through Policies and Procedures**

Management incorporates controls into financial reporting activities by establishing clear accounting policies and developing and implementing accounting procedures. Policies reflect management’s statements of what should be done, guiding the actions of staff. Procedures consist of actions that implement a policy. For example, the Comptroller’s Office sets an accounting policy limiting capitalization of expenditures to only those capital asset purchases with a cost exceeding \$5,000. The procedure identifies the steps needed to record the transaction, which include controls that ensure that all expenditures related to the purchase of capital assets are identified, that they are properly classified, that the city has rights to the assets and that the capitalization threshold is consistently applied.

As noted earlier, much of the recent work performed by the Comptroller’s Office has focused on formally documenting long-standing policies and procedures. This allows the City to have a formal inventory of procedures and related controls that can be systematically monitored for effectiveness and continued relevance. In fiscal year 2015, the Comptroller’s Office documented 118 processes, exceeding its annual goal of documenting 100 processes each year. The Comptroller’s Office is on track to meet its fiscal year 2016 goal of documenting an additional 100 processes.

### **Information and Communication**

The Information and Communication component of the COSO framework supports the functioning of all components of internal control. COSO defines communication as the continual iterative process of providing, sharing and obtaining necessary information. In an organization as large as the City, it is critical that effective communication procedures are established to meet accounting and disclosure requirements under governmental accounting standards and under state and federal securities laws.

Pursuant to SDMC §22.4101 and § 22.4103, a Disclosure Practices Working Group (DPWG) was established by the City, responsible for reviewing financial disclosures for compliance with federal and state securities laws and promoting disclosure best practices. The DPWG includes individuals in key City positions within the City and external counsel that can review



disclosures, communicate known facts and other relevant information and ensure consistency throughout the City's financial disclosure documents.

The DPWG has formal disclosure controls and procedures that define roles and responsibilities over the development and review of financial disclosures. These controls and procedures require that the City's Chief Financial Officer certify to the City Council that the City's financial statements included in the CAFR are fairly presented and that disclosures are true and complete. Similarly, department directors are required to also certify that contributions made by their staff have been reviewed by the director and that the information is accurate and complete.

While the DPWG is responsible for ensuring that disclosures comply with federal and state securities laws, the Comptroller's Office is responsible for ensuring financial statements and related disclosures are prepared in accordance with GAAP. The Comptroller's Office relies on a formal distribution of work document that clearly communicates specific responsibilities for development of the CAFR, including who is responsible for preparing and reviewing the relevant sections of the CAFR.

During the CAFR audit, the independent auditor requests a broad range of supporting documents. The multiple items requested are managed through a master pending list. This allows for effective communication with the independent auditor, as items are clearly assigned to relevant staff and tracked by management throughout the audit process.

The Comptroller's Office relies on a comprehensive accounting and disclosure checklist developed by GFOA. Each question in the checklist is assigned to a staff member within the Comptroller's Office based on area of responsibility. This allows for clear and objective way to ensure compliance with existing governmental accounting standards.

## **Monitoring Activities**

An effective internal control program requires continuous evaluation of each of the five COSO components to ensure that they are functioning effectively. This includes assessing whether risks are being identified timely and if control activities address identified risks. Management should evaluate whether controls are being performed completely, accurately and in accordance with policy. It also includes assessing whether information is being communicated effectively to ensure disclosures are accurate and complete and that accounting policies and procedures are clearly understood by relevant staff.

As part of its monitoring activities, the Comptroller's Office reviews the results of the CAFR independent audit to identify potential areas of risk or areas for which controls need to be strengthened. Independent auditors are required by auditing standards to communicate to the appropriate governing body any material adjustments identified through the audit of the City's financial statements. For the audit of the fiscal year 2015 CAFR, there were no material adjustments identified by the independent auditors. In addition, no material weaknesses or significant deficiencies in internal control over financial reporting were identified in the

*Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards, Reporting and on Compliance and Other Matters*, dated December 8, 2015. The audit of the financial statements is not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. However, the audit process does require significant interaction between the audit team and management and a sustained communication effort throughout the process that allows for effective monitoring of controls over accounting and financial reporting.

The City received the Certificate of Achievement for Excellence in Financial Reporting awarded to the City by GFOA for the fiscal year 2014 CAFR. To receive this award, the City must comply with a comprehensive checklist that incorporates accounting and disclosure requirements in accordance with GAAP. Comments received from GFOA on the submittal of the CAFR also serve as a monitoring tool to ensure controls are effective. If GFOA identifies significant deficiencies in the CAFR, they disqualify a CAFR from being awarded the Certificate of Achievement for Excellence in Financial Reporting. The review of the fiscal year 2014 CAFR resulted in 15 suggestions for improvements, all of which were incorporated into the fiscal year 2015 CAFR. We anticipate receiving the award for the fiscal year 2015 CAFR.

### **Segregation of Duty Monitoring**

The Comptroller's Office continues to monitor for segregation of duty violations to ensure that no one individual has control over an entire process or multiple components of a process which, if abused, could cause harm to the City or to the financial statements. Due to the importance of maintaining controls around segregation of duty violations, continuous monitoring is performed. This monitoring covers in excess of 10,000 users and is performed several times a week to ensure that no violations exist. The section also facilitates monitoring activities performed at the transactional level. Automated testing is developed within the SAP Governance Risk and Compliance module (GRC) and the results are sent to the process owner for review and remediation where necessary.

### **Assessment of Documented Processes and Controls**

A key part of maintaining a strong internal control system is the periodic evaluation and monitoring of processes and their embedded controls. Process design assessments have been developed in the SAP GRC Module with the objective of testing the validity, accuracy and performance of the process as documented. Control design assessments have also been developed to test the presence and performance of controls which have been identified in the process.

In November of 2014, 290 process design assessments and 275 control design assessments were delivered to the respective process owners in the following departments: Comptroller's Office, City Treasurer, Purchasing and Contracting, Financial Management, Debt Management, Risk Management, Department of Information Technology and Public Utilities. The assessments identified 77 processes that required changes to the process and 28 processes that required changes to the related controls. During calendar year 2015, the

Comptroller's Office worked with the respective process owners to resolve the issues identified during the assessment resulting in revisions the processes.

## Conclusion

The City has established a high bar for the development of a comprehensive internal control program for a municipal government. Based on management's evaluation we believe that the internal financial control over the preparation of its Comprehensive Annual Financial Report (CAFR) is effective. We did not identify any significant deficiencies in the design or operation of internal control that could adversely affect the City's ability to record, process, summarize and report financial data. There were no significant changes in internal control, or in other factors, that could significantly affect internal control subsequent to the date of our evaluation.

Management recognizes the importance of formally documenting all significant financial processes and existing controls to increase accountability and reduce the risk associated with employee turnover. We also believe that formal process documentation will improve information and communication and will facilitate monitoring activities to provide a stronger internal control framework.

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## Sources

1. Gauthier, Stephen J. *Evaluating Internal Controls*. Chicago IL: Government Finance Officers Association of the United States and Canada, 2013. Print
2. Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework, Framework and Appendices, 2013*
3. Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework, Internal Control over External Financial Reporting: A compendium of Approaches and Examples, 2013*

RECOMMENDATIONS: N/A

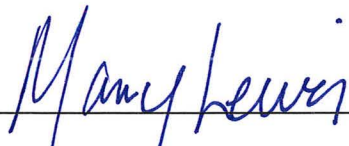
FISCAL CONSIDERATIONS: N/A

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS: N/A

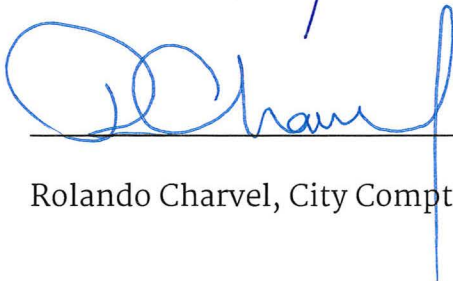
KEY STAKEHOLDERS AND PROJECTED IMPACTS: N/A

Attachments:

1. Certification by the Chief Operating Officer, Chief Financial Officer and City Comptroller
2. Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards, Reporting and on Compliance and Other Matters
3. Report from Macias Gini & O'Connell to those charged with Governance – Fiscal Year 2015 CAFR



Mary Lewis, Chief Financial Officer



Rolando Charvel, City Comptroller

## CERTIFICATION BY MAYOR AND CHIEF FINANCIAL OFFICER

In accordance with the requirements of §22.0708 of the San Diego Municipal Code, the Mayor's designee, the Chief Operating Officer and the Chief Financial Officer 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 22.4102, is made known to the Mayor and/or the Chief Financial Officer by others within the City and its departments, offices, agencies, and affiliated "related entities," particularly during the period in which the Annual Report required by this section is being prepared;
3. have evaluated the effectiveness of the City's internal financial controls as of a date within 90 days prior to the Annual Report;
4. have presented in the Annual Report their conclusions about the effectiveness of their internal controls based on such evaluation as of that date;
5. have disclosed to the City's independent auditors and the Audit Committee 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; and
7. have indicated in the Annual Report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

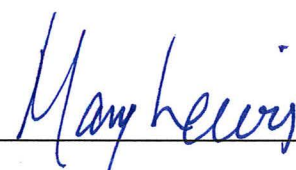
Signed: \_\_\_\_\_



Scott Chadwick, Chief Operating Officer

Date: 29 FEB 16

Signed: \_\_\_\_\_



Mary Lewis, Chief Financial Officer

Date: 2/29/16

Signed: \_\_\_\_\_



Rolando Charvel, City Comptroller

Date: 2/29/16



**Independent Auditor's Report on Internal Control Over Financial Reporting and on  
Compliance and Other Matters Based on an Audit of Financial Statements  
Performed in Accordance With *Government Auditing Standards***

To the Honorable Mayor and City Council  
of the City of San Diego  
San Diego, California

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of San Diego, California (City), as of and for the year ended June 30, 2015, and the related notes to the financial statements, which collectively comprise the City's basic financial statements and have issued our report thereon dated December 8, 2015. Our report includes an emphasis of a matter related to the City's adoption of Governmental Accounting Standards Board (GASB) Statement No. 68, *Accounting and Financial Reporting for Pensions – An Amendment of GASB Statement No. 27* and GASB Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date – An Amendment of GASB Statement No. 68*. Our report also includes a reference to other auditors who audited the financial statements of the San Diego Housing Commission, a discretely presented component unit, as described in our report on the City's financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered the City's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

## **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the City's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that is required to be reported under *Government Auditing Standards*.

## **Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

*Macias Gini & O'Connell LLP*

San Diego, California  
December 8, 2015

**CITY OF SAN DIEGO**

Report to the Audit Committee  
and the City Council

For the Year Ended June 30, 2015



Certified  
Public  
Accountants



**CITY OF SAN DIEGO**  
Report to the Audit Committee  
and the City Council

For the Year Ended June 30, 2015

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December 8, 2015

To the Audit Committee and City Council  
of the City of San Diego

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of San Diego (City) for the year ended June 30, 2015, and have issued our report thereon dated December 8, 2015. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards, *Government Auditing Standards* and OMB Circular A-133, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our letter to you dated June 8, 2015. Professional standards also require that we communicate to you the information related to our audit as discussed in the Required Communications section of this report.

We did not audit the financial statements of the San Diego Housing Commission (Commission), a discretely presented component unit. The Commission's financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the Commission is based solely on the report of the other auditors. This report does not include any communications made by those auditors to those charged with governance of the Commission.

We would like to thank the City's management and staff for the courtesy and cooperation extended to us during the course of our engagement.

This information is intended solely for the use of the Audit Committee, City Council and management of the City and is not intended to be, and should not be, used by anyone other than these specified parties.

Very truly yours,

  
San Diego, California

**CITY OF SAN DIEGO**  
Required Communications  
For the Year Ended June 30, 2015

Significant Audit Findings

*Qualitative Aspects of Accounting Practices*

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the City are described in Note 1 to the financial statements. As described in Note 1v to the financial statements, the City changed its accounting policies related to pensions by adopting Governmental Accounting Standards Board (GASB) Statement No. 68, *Accounting and Financial Reporting for Pensions – An Amendment of GASB Statement No. 27* and GASB Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date – An Amendment of GASB Statement No. 68*. Accordingly, the cumulative effect of the accounting changes reduced net position as of July 1, 2014, on an opinion unit basis, as follows: \$1.4 billion and \$349.8 million for the governmental activities and business-type activities, respectively; \$130.6 million and \$111.5 million for the Sewer Utility and Water Utility major enterprise funds, respectively; and \$159.7 million for the aggregate remaining fund information. We noted no transactions entered into by the City during the fiscal year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the City's financial statements were:

- Management's estimate of the useful lives for depreciable assets is based on the nature of the related capital assets.
- Management's estimate of the allowance for doubtful accounts is based on the historical experience of collections, historical loss levels, and analysis of the collectability of individual accounts, and the legal uncertainty, including the State agency's funding determination regarding collectability of certain interfund loans between the City and the former Redevelopment Agency of the City of San Diego.
- Management's estimate of the workers' compensation, public liabilities, and long-term disability liabilities are based on actuarial valuations using historical loss, employee and other data.
- The net pension liability (NPL), deferred inflows of resources, and pension expense is based upon the actuarial valuation of the total pension liability and net position of the City's defined benefit pension plan.
- Management's estimates of the City's Annual Required Contribution (ARC) for the Preservation of Benefit (POB) plan and Other Postretirement Benefit (OPEB) plan are based on annual actuarial valuations using an accepted actuarial method and various actuarial assumptions. The Net Pension Obligation (NPO) and the Net OPEB Obligation (NOPEBO) are a function of the respective ARC and are estimated by comparing the ARC with the actual funding during the current year and applying an interest rate factor and amortization adjustment factor to the prior year's NPO and NOPEBO.

- Management's estimate of its claims liability and contingencies is based on the development of amounts from actuarial valuations and advice from legal counsel about the ultimate outcome of the claim.
- Management's estimate of the landfill closure and postclosure care liability was based on the percentage of the landfill capacity used to date, which is applied to the estimated total closure costs, monitoring, and postclosure maintenance costs, less the actual costs incurred. Future costs are subject to change as a result of such factors including, but not limited to, inflation, advancements in technology, and amendments to laws and regulations.
- Management's estimate of the fair values of investments, except real estate, infrastructure and private equity investments, are based on quoted market values. Directly held real estate investments fair values are based on recent estimates provided by San Diego City Employees' Retirement System's (SDCERS) contracted real estate managers and third-party appraisal firms. Infrastructure and private equity investments are valued by their respective investment managers, giving consideration to the financial condition and operating results of the portfolio companies, and other factors deemed relevant. The fair values of the infrastructure and private equity investments are reviewed by SDCERS' Private Equity and Infrastructure Consultants.
- We evaluated the key factors and assumptions used to develop these estimates in determining that they are reasonable in relation to the financial statements taken as a whole.

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were:

- The City's NPL and sensitivity of the NPL to changes in the discount rate disclosed in Note 11 to the financial statements.
- The funded status of the City's POB pension plan and the City's NPO disclosed in Note 11 to the financial statements.
- The funded status of the City's OPEB plan and the City's NOPEBO disclosed in Note 12 to the financial statements.
- The commitment disclosure related to the City's future estimated operating and capital costs to comply with the California Regional Water Quality Board's Administrative Proceeding and the City's municipal storm water permit as disclosed in Note 16.
- The disclosure related to contingencies affecting the City as described in Note 17 to the financial statements.

The financial statement disclosures are neutral, consistent, and clear.

#### *Difficulties Encountered in Performing the Audit*

We encountered no significant difficulties in dealing with management in performing and completing our audit.

#### *Corrected and Uncorrected Misstatements*

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are clearly trivial, and communicate them to the appropriate level of management.

Management has corrected such misstatements. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to each opinion unit's financial statements taken as a whole.

#### *Disagreements with Management*

For purposes of this letter, a disagreement with management is a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

#### *Management Representations*

We have requested certain representations from management that are included in the management representation letter dated December 8, 2015.

#### *Management Consultations with Other Independent Accountants*

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the City's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

#### *Other Audit Findings or Issues*

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the City's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

#### Other Matters

We applied certain limited procedures to the management's discussion and analysis, the POB plan schedule of funding progress, the schedule of changes in net pension liability and related ratios, the schedule of employer contributions, OPEB trust fund schedule of funding progress, OPEB trust fund schedule of employer contributions, and the General Fund schedule of revenues, expenditures and changes in fund balance – budget and actual (budgetary basis) and related notes, which are required supplementary information (RSI) that supplements the basic financial statements. Our procedures consisted of inquiries of management regarding the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

We were engaged to report on the combining and individual fund financial statements and schedules, which accompany the financial statements but are not RSI. With respect to this supplementary information, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements.

We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

We were not engaged to report on the introductory section and statistical section, which accompany the financial statements but are not RSI. We did not audit or perform other procedures on this other information and we do not express an opinion or provide any assurance on it.