Performance Audit of the City's Financial Condition

San Diego's Financial Condition for Fiscal Years 2017 and 2018

Office of the City Auditor

City of San Diego

Independent • Objective • Accurate

December 2019

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THE CITY OF SAN DIEGO

December 3, 2019

Honorable Mayor, City Council, and Audit Committee Members
City of San Diego, California

Transmitted herewith is an audit report on the City of San Diego's Financial Condition. This report was conducted in accordance with the City Auditor's Fiscal Year 2020 Audit Work Plan, and the report is presented in accordance with City Charter Section 39.2. The Results in Brief is presented on page 1. Audit Objectives, Scope, and Methodology are presented in Appendix A. Management's comments on our audit can be found on pages 3, 17, and 18.

We would like to thank the Chief Financial Officer, Department of Finance Director & City Comptroller, and their staff for their assistance and cooperation during this audit. All their valuable time and efforts spent on providing us information are greatly appreciated. The audit staff responsible for this audit report are Rod Greek, Chris Kime, and Danielle Knighten.

Respectfully submitted,

Kyle Elser,
Interim City Auditor, CPA, CIA, CFE

cc: Honorable City Attorney Mara Elliott
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Results in Brief

In order to objectively assess and report the City of San Diego's financial condition, we use a well-regarded 10-point test presented by Dean Mead[1] in Public Financial Management (2006).[2] This test is comprised of ten financial ratios designed to assess performance in four areas: financial position, revenues, debt, and capital assets. The test includes both short-term and long-term aspects of financial well-being and relies on audited financial data published in cities' Comprehensive Annual Financial Reports. To give the ratios context, ratios are tracked for multiple years (FY2009 – FY2018) and compared to other cities similar in population and government type (Los Angeles, CA; Phoenix, AZ; San Antonio, TX; Seattle, WA; San Jose, CA; and Austin, TX in our test).

The City of San Diego's financial ratios overall indicate consistent positive financial health from Fiscal Year (FY)2012 through FY2018 and the City's financial condition has been among the best for the last 10 years when compared to six other cities in our test. Overall, the City ranked 1st for the last eight years tested.

While the ten-year trend from FY2009 to 2018 is positive for all the City's financial ratios, especially solvency and debt coverage, we continue to see average results in the capital asset replacement ratio. We are also seeing some negative trends for the ratios associated with financial performance and governmental activities revenues. City Management should continue to monitor these areas;

- Ratio 3 - The Financial Performance ratio measures the rate at which city resources are growing or declining. This ratio demonstrates how well the City was able to pay expenses with revenues from that year. A negative percentage demonstrates diminished financial performance, which indicates the City is in a

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[1] Dean Mead is a Research Manager at the Governmental Accounting Standards Board (GASB).

[2] The modified 10-point test is fully explained in "A Manageable System of Economic Condition Analysis for Governments," which is Chapter 15 of the textbook *Public Financial Management* (CRC Press, 2006).

worse position to face future financial challenges. In FY2018, the City's ratio fell to a negative 2.4%, indicating management should focus on both controlling annual expenses as well as monitoring annual revenues.

- Ratio 6 - The Governmental Activities Revenues ratio measures the degree to which governmental activities are supported by taxes and other general revenues. This ratio shows the extent to which governmental activities' functions and programs are self-financed or the degree to which they depend on financing from governmental revenues, primarily taxes. A low ratio suggests services are less reliant on general revenue financing and are more self-supporting through charges for services, grants, and contributions. Both FY2017 and FY2018 show an increase from FY2016 in the reliance on general revenues from 60% to 69%. Again, this is a concern that should be monitored by management.
- Ratio 10 – Net Change in Capital Assets Value is trending in a positive direction over the ten-year review period, but it remains the City's lowest ranking metric. One-time spikes due to the addition of large capital projects can be anticipated, but long-term under-performance in this metric can be an indication that the City is under investing in its infrastructure when compared with other cities. We have seen improvement over the last two years with San Diego above the average of the comparable cities.

We've also included information on the City of San Diego's Pension, Other Post-Employment Benefits (OPEB) as well as its Contingent Liabilities and Commitments. Contingent liabilities may or may not become legal commitments of future city resources. Pension, OPEB and Commitments identify significant future long-term liabilities for the City. Information is included in this report to ensure management and policy makers are aware of the existence and the need to actively manage these liabilities.

In FY2016, the city had a contingent liability related to approval of a waiver for secondary treatment at the Pt. Loma Wastewater Treatment Plant. In FY2017, the waiver was approved, and as a result the contingent liability was reclassified to a commitment. Phase one of the commitment is for the City to move forward with the Pure Water Project. The estimate for phase one as of June 30, 2018 is included in the Commitment section of this report. We have observed a 38% increase in the estimates for Commitments from FY2016 to FY2018. As of June 30, 2018, the liabilities for commitments exceed $5.3 billion over a 17-year period from FY2019 - FY2035. The City of San Diego has recovered from financial challenges in the last decade, and it is a credit to stakeholders that we are seeing results from the steps taken. The Chief Financial Officer for the City stated,

"The Mayor and Council have maintained sound financial policies and practices over the years, allowing the City to continue to build upon its strong financial standing. In addition to maintaining cash reserves to protect the City from economic downturns, unforeseen events and increases in pension costs, the City adopts a structurally balanced budget each year, maintains strong expenditure controls, conducts long-term financial planning and adheres to responsible and equitable debt practices."

This audit is an update of our previous report in FY2018 as we continue to monitor the City's financial condition. Financial decisions can only be as sound as the information upon which they are based. Therefore, a government's financial condition must be continually monitored and regularly evaluated to help ensure the City's decisions are fully informed and financially responsible. Financial ratio analysis should raise questions that seek to explain the differences between cities and evaluate the reasons for change over time. Utilizing a peer comparison group provides some context for understanding the results of the analysis. While no two entities provide exactly the same services, we've selected peers based on size, type, and geographic region. The discussion of financial ratios can lead to meaningful answers for policy-makers and stakeholders.

Background

What Is Financial Condition?

Financial condition can be broadly defined as a local government's ability to finance its services on a continuing basis. More specifically, financial condition refers to a government's ability to:

- Maintain existing service levels;
- Withstand economic disruptions; and
- Meet the demands of growth, decline, and change.

A basic assessment of a local government's financial condition involves evaluating whether the local government can continue paying for what it is doing, whether there are reserves for financing emergencies, and whether there is enough financial flexibility to allow the government to adjust to change. If a government can meet these challenges, it is in sound financial condition. If not, it is probably experiencing or can anticipate financial problems.

San Diego Base Economy

The City's financial condition depends in many ways on the economic environment. According to the City's Economic Development Strategy for 2017 through 2019, the City's economy is based on four industries:

1. Manufacturing and Innovation;
2. International Trade and Logistics;
3. Military Installations; and
4. Tourism.

These are sectors that bring money and wealth into the region. Therefore, growth or disruptions in these industries may have an effect on the City's financial condition.

Budget

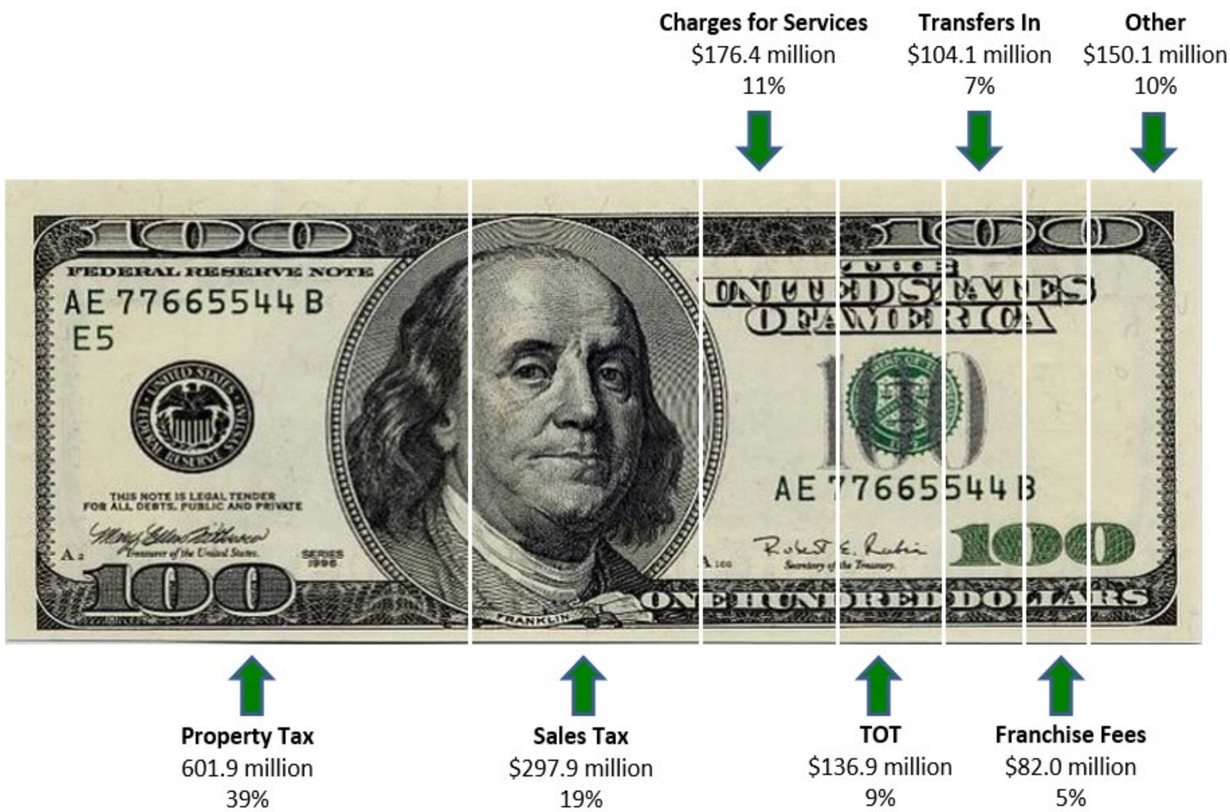
The City's Fiscal Year (FY)2020 Adopted Budget totals $4.3 billion and incorporates projections for an improved economic outlook based on the continuing trend of increases in Property, Sales and Transient Occupancy Taxes. The FY2020 Adopted Budget includes $1.6 billion for General Fund operations, $2.0 billion for operations of the City's Enterprise Funds and all other funds, and $728 million for capital improvement projects across the City.

General Fund Revenue Sources

In the City's FY2020 Adopted Budget, the General Fund's largest outside revenue sources are property tax, sales tax, Transient Occupancy Tax (TOT), and franchise fees. The General Fund is supplemented by charges for services, transfers in, and other miscellaneous funds. **Exhibit 1** breaks down the revenue sources that finance the City's General Fund.

Exhibit 1:

Fiscal Year 2020 Adopted Budget, General Fund Revenue



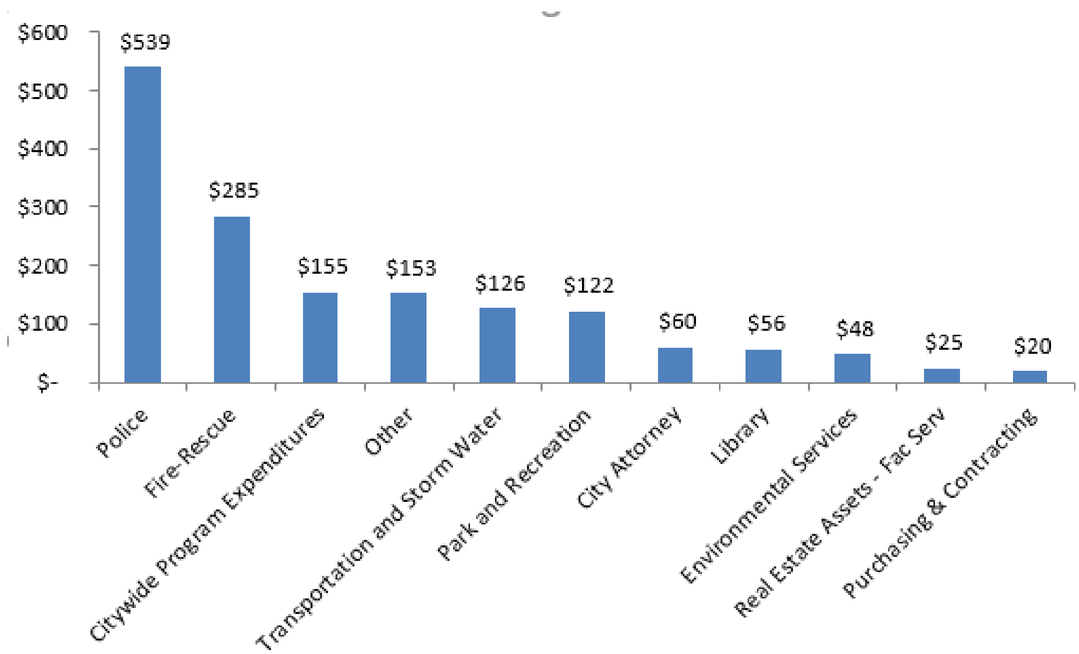
Source: City Auditor generated.

General Fund Expenditures

The City's FY2020 Adopted Budget reflects General Fund expenditures totaling $1.6 billion and 7,728 budgeted full-time equivalent positions. Departments within the General Fund provide core community services, such as public safety (including police and fire protection), parks and recreation, library services, and refuse collection, as well as vital support functions such as finance, legal, and human resources. These core services are primarily supported by major revenue sources, as previously described. **Exhibit 2** summarizes the FY2020 Adopted General Fund budgeted expenses by department, with those departments having a total General Fund expenditure budget of less than $20 million combined in the "Other" category.

Exhibit 2:

FY2020 Adopted Budget, General Fund Expenditures by Department (in Millions)



Note: The Other category includes: City Auditor, City Clerk, City Council, City Treasurer, Communications, Debt Management, Department of Finance, Department of Information Technology, Development Services, Economic Development, Ethics Commission, Government Affairs, Human Resources, Infrastructure/Public Works, Internal Operations, Neighborhood Services, Office of Boards & Commissions, Office of Homeland Security, Office of the Assistant COO, Office of the Chief Financial Officer, Office of the Chief Operating Officer, Office of the IBA, Office of the Mayor, Performance & Analytics, Personnel, Planning, Public Utilities, Real Estate Assets, Smart & Sustainable Communities, and Sustainability.

Source: FY2020 Adopted Budget.

Debt Obligations

The outstanding principal for the City's existing long-term debt obligations[3] as of June 30, 2018 are as follows:

- General Fund backed Lease-Revenue Bonds and Capital Lease Obligations: $583.5 million.
- Public Utilities-Water System Obligations: $711.4 million.
- Public Utilities-Wastewater (Sewer) System Obligations: $869.3 million.

Departments Involved in Managing San Diego's Financial Condition

The City's financial condition is multi-faceted and depends on the work performed by several departments, which are overseen by the Chief Financial Officer (CFO):

- Department of Finance—financial reporting, budgeting, fiscal consulting, disbursements, payroll and internal controls;
- City Treasurer—receivables, banking, and investments;
- Debt Management—financing; and
- Risk Management—financial risk management, self-insurance programs.

In addition to the departments overseen by the CFO, the Office of the Independent Budget Analyst assists the City Council with budgetary inquiries and budgetary decisions. For more about these departments and their responsibilities, refer to **Appendix B**.

New Accounting Standard Impacting Ratios

The Governmental Accounting Standards Board (GASB) Statement 75 – Accounting and Financial Reporting for Post-Employment Benefits other than Pensions- is effective for FY2018 going forward. Implementation of this standard required governments to include the entire Net Other Post-Employment Benefits (OPEB) Liability in the financial statements. The following ratios will be impacted by this new Standard:

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[3] These do not reflect debt obligations of City related entities (including the City as the Successor Agency to the Redevelopment Agency), Community Facilities Districts, or Special Assessment Districts.

- Financial Performance;
- Solvency; and
- Primary Government Liabilities Per Capita.

This standard also required governments to enhance the footnote disclosure related to OPEB. We have added a section in this report following the ratio analytics to include City of San Diego's Pension and OPEB statistics.

Assessing Financial Condition

Several methods, with varying degrees of complexity and comprehensiveness, exist for assessing a local government's financial condition. We selected the modified 10-point test, as presented by Dean Mead in *Public Financial Management*, because it incorporates both short-term and long-term aspects of a city's financial well-being, while being relatively straightforward and easy to use.[4]

California State Auditor Financial Comparison of California Cities

The California State Auditor (State Auditor) analyzed financial information for 471 California cities to identify cities that may be at risk of fiscal distress. They assessed risk by performing various financial comparisons and calculations referred to as financial indicators. Their analysis relied upon information from audited financial statements prepared in accordance with generally accepted accounting principles (GAAP) as well as unaudited pension related information from the California Public Employees' Retirement System (CalPERS) and the State Controller.

Similar to this report, they selected a set of 10 indicators to assess each city's ability to pay its bills in both the short and long term. Specifically, the indicators measure each city's cash position or liquidity, debt burden, financial reserves, revenue trends, and ability to pay for employee retirement benefits. The City of San Diego ranked 411th out of 471. However, we noted that 347 of the cities in their study were small with populations less than 70,000 and as little

[4] Appendix A of this report further explains the rationale for using this method.

as a population of 83. Two cities included in this report were also included in the State Auditor's report and those cities received comparatively lower rankings than the City of San Diego in both reports.

Comparing large cities against small cities can be problematic. For instance, smaller cities generally have smaller capital projects and cash fund those projects, whereas large cities need to debt finance large projects because it makes sound fiscal sense to do so. In addition, smaller cities typically have a greater percentage of reserves when compared to their annual expenses as both are relatively low balances when compared to larger cities. For example, it would not be unusual to see small cities have in excess of six months of expenses available in unreserved balances. GFOA recommends a minimum of 60 days of unrestricted reserves; however, they also note an exception for larger governments due to more diverse revenue sources and less volatility in expenses.

The ratios in which the City of San Diego under-performed compared to other California cities were General Fund Reserves (weighted 30%), and Debt Burden (weighted 15%). However, the State Auditor calculation excluded the City's Emergency Reserve of $96.7 million, (over half of San Diego's reserves), in its calculation as the City includes this reserve in Restricted Net Assets unlike most other cities which generally include Emergency Reserves in Unrestricted Net Assets. According to the Government Finance Officers Association best practice advisory on Fund Balance for the General Fund, "Sometimes restricted fund balance includes resources available to finance items that typically would require the use of unrestricted fund balance (e.g. contingency reserve). In that case, such amounts should be included as part of unrestricted fund balance for purposes of analysis." When the Emergency Reserve is included in the calculation, the City of San Diego has adequate reserves of 12.8% which equates to 47 days coverage. When compared to cities of similar size, San Diego is the top performer in all the debt coverage ratios.

10-Point Test and Comparable Cities

The original 10-point test, introduced by Dr. Ken Brown in 1993, addressed four factors relevant to financial well-being—revenues, expenditures, operating position, and debt structure. However, Mead argues that it focuses nearly entirely on the short-term finances of governmental activities. According to Mead, any financial analysis should encompass both short- and long-run financial information. Furthermore, not only should the government as a whole be considered, but governmental activities should be considered separately from the business-type activities to distinguish financial results that may be masked when information is aggregated at the government-wide level. Finally, Mead suggests that to make the financial ratios of the 10-point test most meaningful, they need the context provided by a comparison to prior years and similar governments.

The 10-point test begins with the calculation of 10 ratios for the benchmark cities pulled from Comprehensive Annual Financial Reports (CAFRs)[5] for the ten preceding years. Each ratio is then compared and scored with ratios computed for a peer group of similar governments (in terms of population, total revenues, geographic proximity, or other measure) from CAFRs during the same period of time. The total score can also be rated against the scores of comparable governments. The 10 ratios and their descriptions are shown in **Exhibit 3**.

[5] Appendix C provides more information on CAFRs and specific financial statements used in this audit.

Exhibit 3:

10-Point Test Ratios and Descriptions

Category	Ratio	Ratio Description
Financial Position	1. Short-run Financial Position	Ability to handle unforeseen resource needs over the short-term.
	2. Liquidity	Ability to meet short-term obligations with current assets.
	3. Financial Performance	How well the City was able to pay expenses with revenues from that year.
	4. Solvency	City's overall capacity for repaying all of its obligations based on annual revenue.
Revenues	5. Primary Government [6] Revenues	Flexibility of City's revenues based upon reliance on intergovernmental aid, including grants.
	6. Governmental Activities[7] Revenues	Extent to which Governmental Activities are self-financed or dependent upon taxes.
Debt	7. Primary Government Debt Burden	Long-term debt burden upon City's residents. (Maturity greater than one year).
	8. Government Funds Debt Coverage	The principle and interest that the City must pay each year on debt as a percentage of operating costs.
	9. Enterprise Funds Debt Coverage	The sufficiency of resources available to repay business-type debt.
Capital Assets	10. Net Change in Capital Assets Value	Change in net value of assets for primary government. (Compares rate of investment in capital assets to depreciation of assets.)

Source: Public Financial Management – Chapter 15.

[6] See Appendix C.1. for definition of Primary Government

[7] See Appendix C.1. for definition of Governmental Activities

In using the modified 10-point test to assess the City's financial condition, we selected six cities for comparison based on government type and population size. We selected three US cities with populations greater than San Diego (Phoenix, Los Angeles, and San Antonio), and three US cities with populations smaller than San Diego (Seattle, San Jose, and Austin) for inclusion in the comparison group.[8]

Investor Caveat

The Office of the City Auditor developed this report, and it is intended for the public. The report is the result of a performance audit and was not part of the annual audit of the City's financial statements. Expressions of opinion in the report are not intended to guide prospective investors in securities offered by the City.

[8] Refer to Appendix A of this report for more on the rationale for using population size as a basis of comparison.

Audit Results

San Diego's financial condition scored among the best compared to the benchmark cities, improving over the last ten-years as the scores have trended upward and stabilized at a healthy score of 15 or 16 for three of the last four fiscal years (FY).

However, the overall San Diego score dropped from 16 to 12 from FY2017 to FY2018 due to a one-point drop in four of the ratio scores when compared to the test cities. These were Liquidity (ranked tied for 3rd), Financial Performance (ranked 5th), Primary Government Revenues (ranked 3rd) and Governmental Activities Revenues (ranked 5th).

San Diego’s individual ratio scores were calculated based upon awarding two points for each ratio that fell in the top quartile (top 25 percent) of the comparison group. One point was given for each in the second quartile, and no points for a ratio in the third quartile. A point was subtracted for a ratio in the lowest quartile. San Diego’s ratio scores are summarized below in **Exhibit 4** by fiscal year.

Exhibit 4:

San Diego Financial Condition Ratio Scores

Ratio	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total
Short-Run Financial Position	0	0	1	1	1	1	1	1	1	1	8
Liquidity	0	0	1	2	1	1	1	0	2	1	9
Financial Performance	1	1	0	1	2	1	2	2	1	0	11
Solvency	1	1	1	2	2	2	2	2	2	2	17
Primary Government Revenues	2	2	2	2	2	2	2	2	2	1	19
Governmental Activities Revenues	1	0	0	0	2	2	2	2	1	0	10
Primary Government Debt Burden Per Capita	2	2	2	2	2	2	2	2	2	2	20
Governmental Funds Debt Coverage	2	2	1	2	2	2	2	2	2	2	19
Enterprise Funds Debt Coverage	1	1	2	1	0	1	1	2	2	2	13
Net Change in Capital Assets	-1	0	-1	-1	1	0	1	0	1	1	1
Annual Totals	9	9	9	12	15	14	16	15	16	12	

Source: City Auditor generated.

San Diego's highest scores for the ten-year period were related to debt and Primary Government Revenues, while the lowest score was in capital assets, based on the scale of -10 being the lowest and 20 points being the highest. Solvency remains strong for the City; however, both pension and Other Post-Employment Benefits (OPEB) liabilities are now part of this metric resulting in a less robust solvency ratio.

The City's capital asset ratio has improved the most going from -1 to a 1 over the last ten-years, but remains the City's lowest ranking metric.

Over the last two years, the Financial Performance and Governmental Activities Revenues ratios have been declining. This is an indication that governmental funds are becoming stressed and are less able to meet annual expenses without external sources of revenue. One of the main reasons for the decline in these ratios is due to the implementation of Governmental Accounting Standards Board's (GASB) 68 and 75.

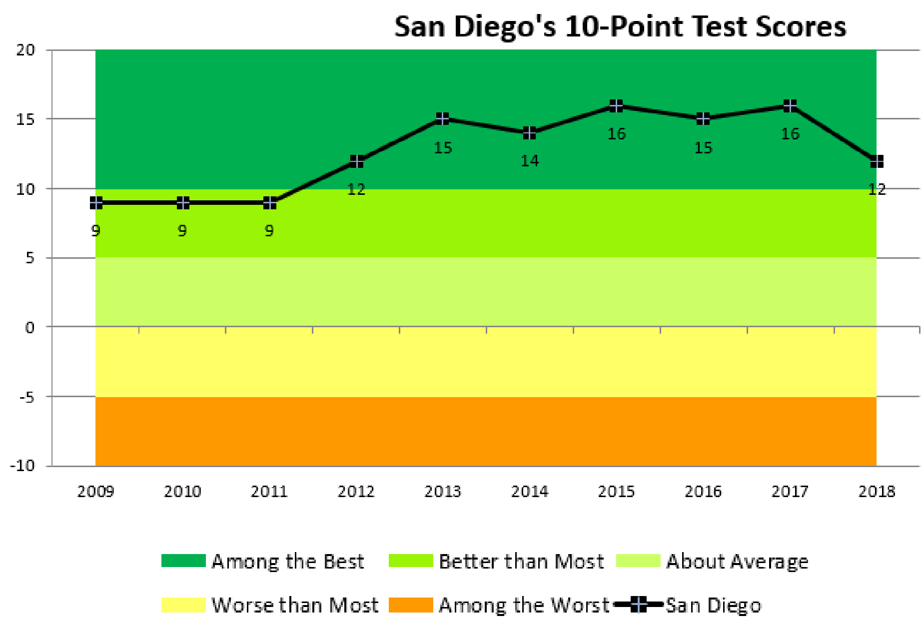
San Diego's 10-Point Test Score

San Diego's financial condition scored the best compared to the benchmark cities as shown in **Exhibits 5-7**. The strongest ratios for San Diego include Primary Government Revenues, Primary Government Debt Burden per Capita and Governmental Funds Debt Coverage. The City has been ranked among the best from FY2012 through FY2018.

Exhibit 5:

San Diego 10-Point Test Scores

(Higher is better)



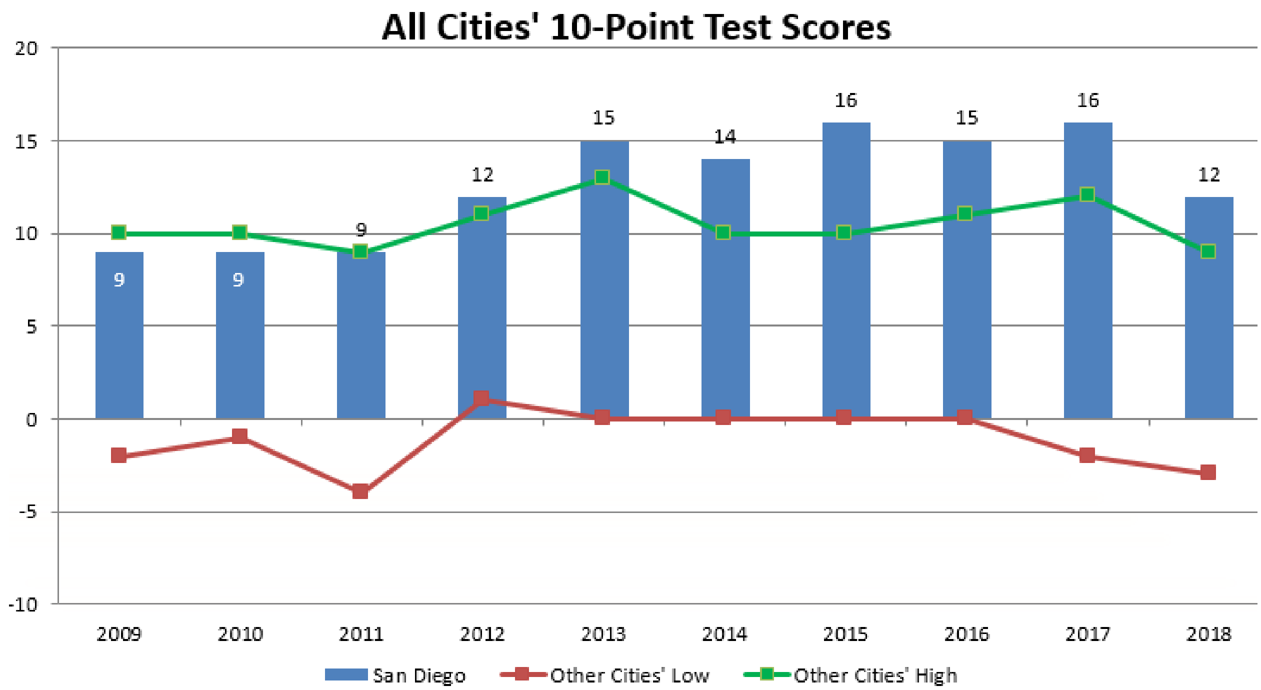
Source: City Auditor generated.

San Diego Score Compared to Benchmark Cities

San Diego's FY2018 score of 12 exceeded the other cities' scores, which ranged between a high of 9 and low of -3. The highest score for any of the other cities during the ten-year period was 13 in FY2013. San Diego's score was at least four points higher than the other cities' highest score for FY2014 through FY2017. **Exhibit 6** shows San Diego's score in relation to the other tested cities' high and low scores.

Exhibit 6:

San Diego's Score Comparison



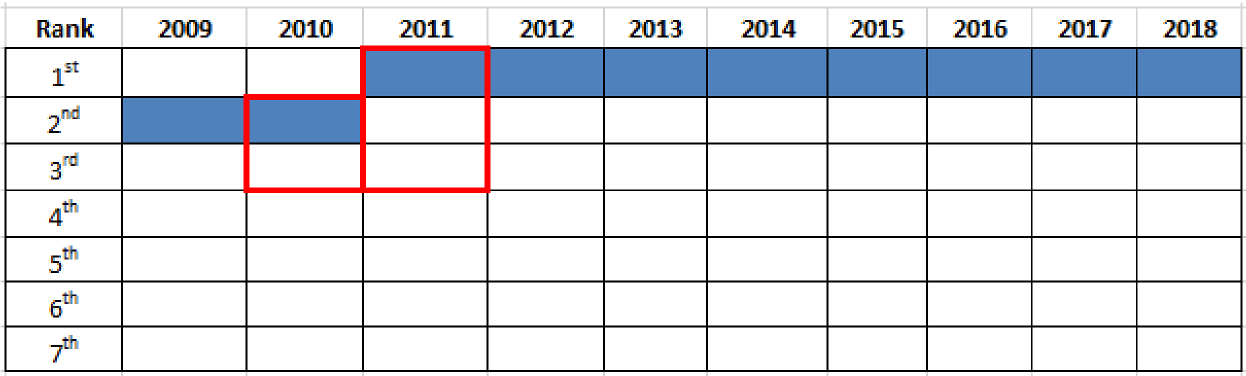
Source: City Auditor generated.

San Diego Ranked to Benchmark Cities

San Diego was ranked either first or second for all the years during the test period. The City was ranked tied for first in FY2011 and ranked number one from FY2012 through FY2018. **Exhibit 7** displays the City's annual rank.

Exhibit 7:

San Diego’s Annual Rank



Source: City Auditor generated.

Chief Financial Officer Remarks Related to the City’s Scores

As the report indicates, the City’s financial indicators continue to outperform comparative cities, with San Diego being the highest overall ranked among the seven cities included in the report. The results of the audit are consistent with the City's strong credit ratings. The City maintains ratings in the second highest rating category from three of the national credit rating agencies. These include "AA" ratings from Standard and Poor's and Fitch Ratings and Aa2 from Moody's Investors Service.

The Mayor and Council have maintained sound financial policies and practices over the years, allowing the City to continue to build upon its strong financial standing. In addition to maintaining cash reserves to protect the City from economic downturns, unforeseen events and increases in pension costs, the City adopts a structurally balanced budget each year, maintains strong expenditure controls, conducts long-term financial planning and adheres to responsible and equitable debt practices.

It is important to note that the metrics included in this report are based on formulas that provide a high-level and limited view of each city's financial condition. A more complete financial assessment can only be achieved through a careful review and understanding of each city's annual financial statements and note disclosures. Even when comparing cities of similar population, there may be significant differences between them, including different functions performed for their residents, differences in socioeconomic, political and regulatory environments in addition to opportunities and limitations afforded by their geographic location and natural environment. There are also differences relating to revenue or debt raising ability among local agencies in California compared to localities in other states. Similarly, the assumptions used to measure and fund Pension and Other Post Employment liabilities can vary significantly between cities.

Ratio 1: Short-Run Financial Position

Formula = Unreserved General Fund Balance ÷ General Fund Revenues

The short-run financial position ratio measures the City's ability to handle unforeseen resource needs over the short-term.

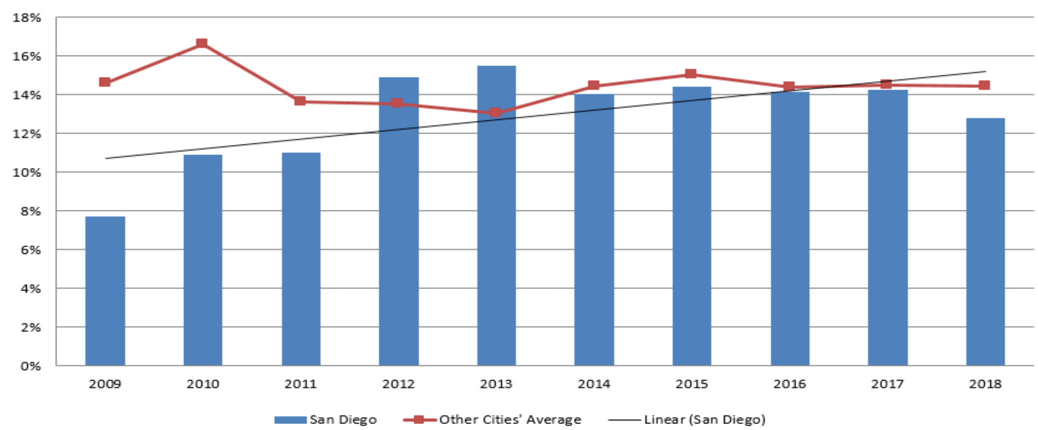
The City of San Diego had over $192 million in Unassigned and Emergency Reserve General Fund Balance that equaled 13% of General Fund Revenues at the end of FY2018. This means that the City's FY2018 Unreserved General Fund balance would be sufficient to keep the City's basic functions running for approximately 47 days. GFOA recommends a minimum of 60 days, however there is an exception for larger cities, counties, state and other large government entities as revenues and expenditures are often more diversified and less subject to volatility.

Exhibit 1:

Short-Run Financial Position

(Higher is better)

A high ratio suggests larger reserves for dealing with unexpected resource needs in the near-term.



Source: City Auditor generated.

For seven out of the ten-year period, San Diego's ability to meet short-term needs was below the benchmark cities average. San Diego's ratio has improved however going from 6.9 percentage points below the average in FY2009 to only 1.7 percentage points below the average for the other cities in FY2018. The main reason for the decrease from FY17 to FY18 is due to the use of $16 million from the Pension Stabilization Reserve to meet the funding requirements for pension plan.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1st										20.6%
2nd										19.6%
3rd										17.3%
4th										**12.8%**
5th										10.9%
6th										9.9%
7th										8.4%

Source: City Auditor generated.

San Diego's ranking has been stable compared to the other cities, ranking fourth for the last five years.

Ratio 2: Liquidity

Formula = General Fund Cash and Investments ÷ (General Fund Liabilities − General Fund Deferred Revenues)

The liquidity ratio measures the City's ability to meet its short-term obligations with current assets. Although liquidity changes constantly, an annual year-end look is useful. Unless the government experiences major changes in receipt of revenues or disbursement of funds, the City should be at the same point in its cash flow cycle at the end of each year. A low ratio can be a warning that may indicate a cash flow problem and a need for short-term borrowing. Specifically, a ratio below 1.0 suggests an inability to pay current obligations.

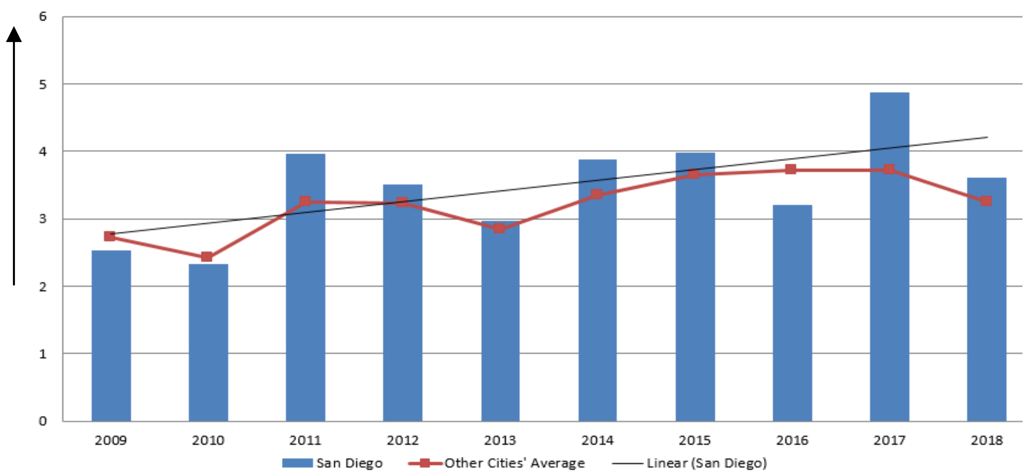
The City of San Diego's liquidity ratio has remained relatively stable in the last eight years with a high of 4.9 in FY2017. This means that the City had the capacity to pay current bills almost five times over in FY2017.

Exhibit 1:

Liquidity

(Higher is better)

A high ratio suggests a greater capacity for paying off short-run obligations.



Source: City Auditor generated.

The City's liquidity ratio has improved during the ten-year period and was above average for benchmark cities for seven of the years. This suggests that San Diego's capacity to pay current bills is better than most of the benchmark cities.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1st										4.5
2nd										4.1
3rd										**3.6**
4th										3.6
5th										3.4
6th										1.9
7th										1.7

Source: City Auditor generated.

At the beginning of the ten-year period, San Diego was ranked fifth, improving to second ranking in FY2012 and 2017, but dropping to third in FY2018.

Ratio 3: Financial Performance

Formula = Change in Governmental Activities Net Assets ÷ Total Governmental Activities Net Assets

The financial performance ratio measures the rate at which a city's financial resources are growing or declining. Utilizing the change in net assets for governmental activities, this ratio demonstrates how well the City was able to pay expenses with revenues from that year. In other words, the ratio demonstrates the City's ability to make ends meet. A positive percentage demonstrates improved financial performance, which indicates the City is in a better position to face future financial challenges. This ratio is highly sensitive to economic factors outside the City's control, such as a decline in tourism as a result of a recession. Although a high ratio suggests the City is doing a better job of balancing revenues and expenses each year, a very high ratio could suggest that a city is raising too much revenue or under-spending on needed services.

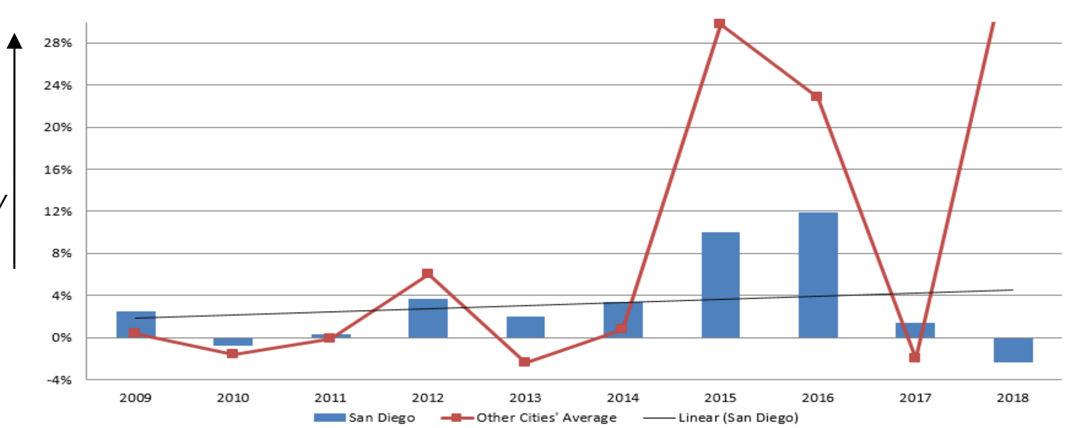
The City of San Diego's financial performance ratios during the ten-year period ranged from a high of 11.9% in 2016 to a low of -2.4% in 2018. The City's revenues fell short of expenses by $97,429,000 in FY2018, and net assets decreased by 6.5% as a result of the implementation of GASB 75 and the revenue shortfall. By comparison, the average decrease in net assets for the other cities was 46.9% and was mainly due to implementation of GASB 75.

Exhibit 1:

Financial Performance

(Higher is better)

A high ratio suggests that annual costs are being adequately financed and financial positon is improving.



Source: City Auditor generated.

San Diego's ten-year trend is only positive due to the strong performance in FY2015 and FY2016. FY2017 and FY2018 ratios are an indication the City has a challenge in meeting annual expenses with annual revenues. The ratios of the benchmarked cities have ranged from a high of 245.4% to a low of -39.0% over the ten-year period. The extreme positive ratio for benchmark cities in FY15, FY16 and FY18 was due to substantially decreased net position balances due to the implementation of GASBs 68 and 75.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1st										245.4
2nd										8.8
3rd										7.9
4th										3.4
5th										**-2.4**
6th										-10.7%
7th										-27.2%

Source: City Auditor generated.

FY2018 was only the second time this metric was negative. A trend of decline in this ratio over the past two years is an indication the City may be struggling to meet annual commitments with annual revenues, or it may be the result of a one-time event such as implementation of a new accounting standard.

Ratio 4: Solvency

Formula = (Primary Government Liabilities − Deferred Revenues) ÷ Primary Government Revenues

The solvency ratio adds a long-run dimension to the analysis of the City's operating position. It is an indicator of the City's overall capacity for repaying or otherwise satisfying all its outstanding obligations based on annual revenue. A low ratio suggests that annual revenues are sufficient for satisfying the City's liabilities.

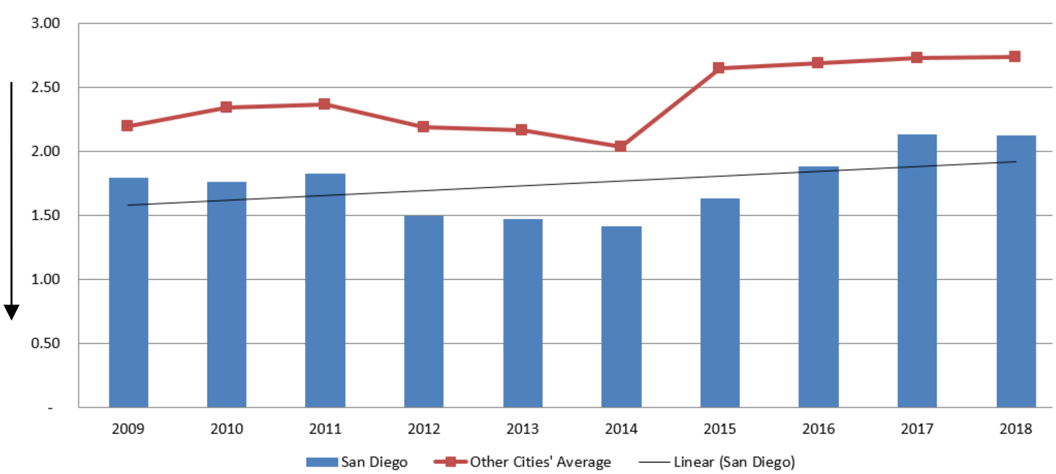
San Diego's solvency ratio has been relatively stable over the analysis period ranging from a high of 2.13 in FY2017 to a low 1.42 in FY2014. In FY2018, the City would have needed $3.6 billion of additional revenue to cover all its outstanding obligations. This means that the City's liabilities were 120 percent greater than the sum of annual revenues. This includes all long-term liabilities including Pension and Other Post-Employment Benefits (OPEB - Retiree Health) for FY2018. However, long-term liabilities are intended to be paid off over long periods of time with only a small portion being paid down in any one year.

Exhibit 1:

Solvency

(Lower is better)

A low ratio suggests outstanding obligations can more easily be met with annual revenues.



Source: City Auditor generated.

San Diego's solvency results could be considered positive because the ratio had declined leading up through FY2014 and because the ratios were consistently below benchmark cities.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1st										2.05
2nd										**2.12**
3rd										2.33
4th										2.87
5th										2.88
6th										3.10
7th										3.19

Source: City Auditor generated.

San Diego has been consistently ranked above average for the ten-year period compared to the benchmark cities, improving from the 3rd ranking during the first three years to 1st in five of the last seven years. One benchmark city marginally outperformed San Diego in FY2017 and FY2018.

Ratio 5: Primary Government Revenues

Formula = (Primary Government Operating Grants and Contributions + Unrestricted Aid) ÷ Total Primary Government Revenues

The primary government revenues ratio measures the flexibility of the City's revenues. The ratio considers different sources of revenues of the primary government, including business-type activities. Intergovernmental aid is revenue generated from other government entities and includes grants. Reliance on intergovernmental aid can be risky during an economic downturn because federal and state agencies frequently withdraw or reduce payments to local governments as a cutback measure.

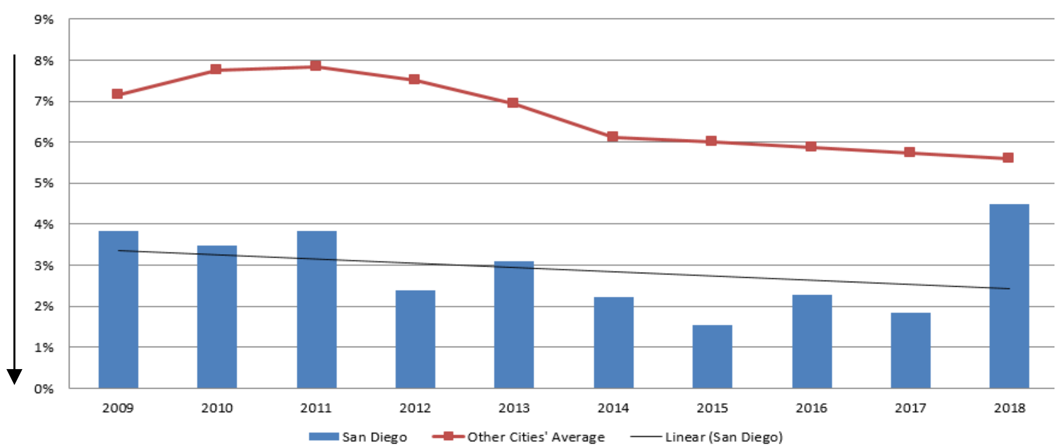
That said, it is important for local governments to maximize the acquisition of State and Federal Grants as they directly benefit the local economy. Prudent planning should be incorporated to anticipate the impacts of economic downturns and the impact it will have to the availability of intergovernmental funding. The increase in the FY2018 ratio was mainly due to an increase in operating grants associated with transportation and neighborhood services.

Exhibit 1:

Primary Government Revenues

(Lower is better)

A low ratio suggests a government is not heavily reliant on intergovernmental aid.



Source: City Auditor generated.

San Diego's 4.5 percent ratio in FY2018 was 1.1 percentage points below comparison cities, showing that the City is not as heavily reliant on intergovernmental aid as other benchmark cities. San Diego's ratios consistently remained below the average of benchmark cities during the review period.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1st										1.1%
2nd										3.8%
3rd										**4.5%**
4th										5.2%
5th										5.6%
6th										7.8%
7th										10.3%

Source: City Auditor generated.

The City maintained a 2nd place ranking for nine years, slipping to third in FY2018 due to the increase in operating grants for San Diego.

Ratio 6: Governmental Activities Revenues

Formula = Net Revenue (Expense) for Governmental Activities ÷ Total Governmental Activities Expenses

The governmental activities revenues ratio measures the degree to which governmental activities are supported by taxes and other general revenues. This ratio shows the extent to which governmental activities' functions and programs are self-financed or the degree to which they depend on financing from governmental revenues, primarily taxes. A low ratio suggests services are less reliant on general revenue financing and are more self-supporting through charges for services, grants, and contributions.

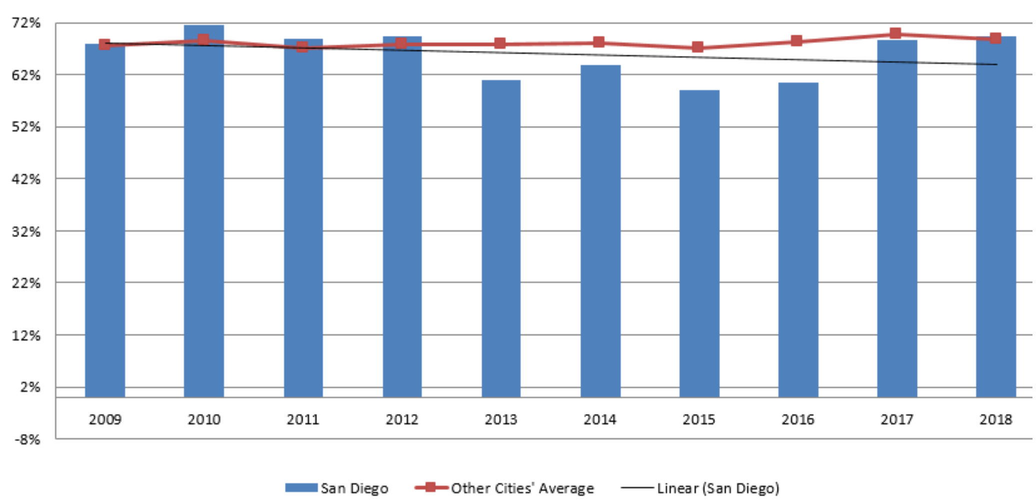
The City of San Diego has maintained relatively level taxpayer support for governmental activities, ranging between 59 percent and 71 percent during the ten-year review period. In FY2018, Governmental Activities generated almost $644 million, which fell short of the expenses by almost $1.46 billion. This means 69 percent of expenses had to be funded through taxes and other general revenues. During FY2017 and FY2018 San Diego has increased reliance on general tax support from the low of 59 percent in FY2015 to 69 percent in FY2018.

Exhibit 1:

Governmental Activities Revenues

(Lower is better)

A low ratio suggests basic government services are more self-sufficient and less reliant on general tax support.



Source: City Auditor generated.

While the overall trend is positive with downward movement due to the decreases in FY2013 through FY2016 there has been a trend reversal in FY2017. The first four years and FY2018 were worse than the average for the benchmark cities.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1st										56.6%
2nd										66.9%
3rd										67.4%
4th										67.6%
5th										**69.4%**
6th										75.8%
7th										78.6%

Source: City Auditor generated.

In FY2013 through 2016 San Diego was ranked 1st or 2nd. Since then, San Diego has moved towards the back of the benchmark cities.

Ratio 7: Primary Government Debt per Capita

Formula = Total Outstanding Primary Government Long-Term Debt ÷ Population

The primary government debt burden per capita ratio identifies the level of long-term debt[9] burden on the City's residents. A low ratio suggests there is less debt burden imposed on taxpayers and a greater potential capacity for additional borrowing.

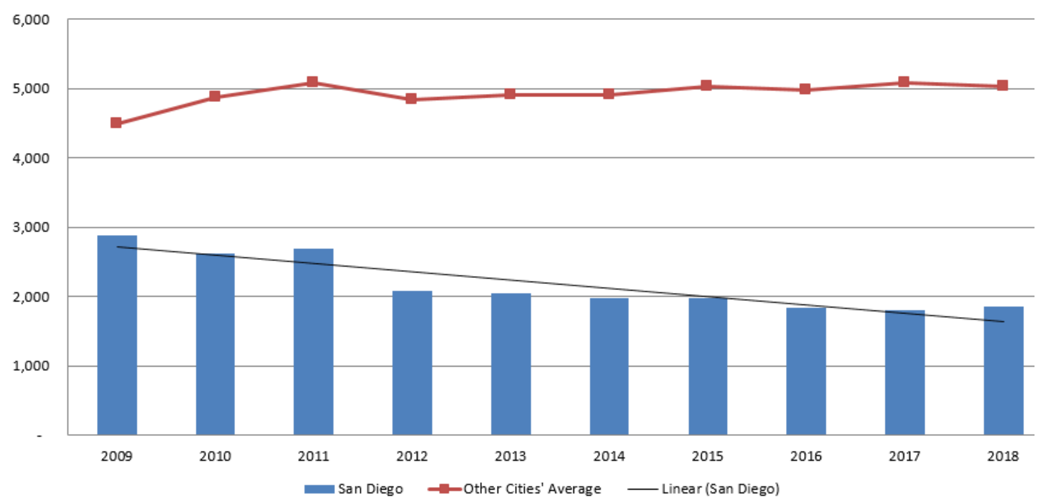
In FY2018, the total outstanding debt for the City of San Diego was $2.5 billion. The City's per capita debt burden has trended downward, from $2,876 in FY2009 to $1,854 in FY2018.

Exhibit 1:

Primary Government Debt per Capita

(Lower is better)

A low ratio suggests less burden on taxpayers and greater capacity for additional borrowing.



Source: City Auditor generated.

San Diego has maintained a level of long-term debt well below the average of benchmark cities. For example, the average for benchmark cities in FY2018 was $5,030 debt per capita, and the highest ratio was $7,987 debt per capita. This suggests the City of San Diego is in a better position than benchmark cities to repay outstanding debt as well as for future borrowing.

[9] Long-term debt has a maturity of more than one year after issuance.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1st										**$ 1,854**
2nd										$ 2,193
3rd										$ 2,203
4th										$ 3,993
5th										$ 6,771
6th										$ 7,036
7th										$ 7,987

Source: City Auditor generated.

San Diego has ranked first since FY2014. San Diego's benchmark cities. San Diego's debt per capita has dropped by $1,023 since FY2009, remaining in the 1st place since FY2014.

Primary Government Liabilities per Capita

Formula = Total Primary Government Long-Term Liabilities ÷ Population

In addition to the primary government debt ratio, we calculated a ratio of all long-term liabilities, which was not part of the 10-point test. We calculated this ratio to assess whether the City's long-term liabilities were significantly different from its long-term debt. In addition to long-term debt, long-term liabilities included arbitrage liability, compensated absences, liability claims, estimated landfill closure and post closure care, net other post-employment benefits obligation, and net pension obligation. More information regarding Pension & OPEB can be found at page 40.

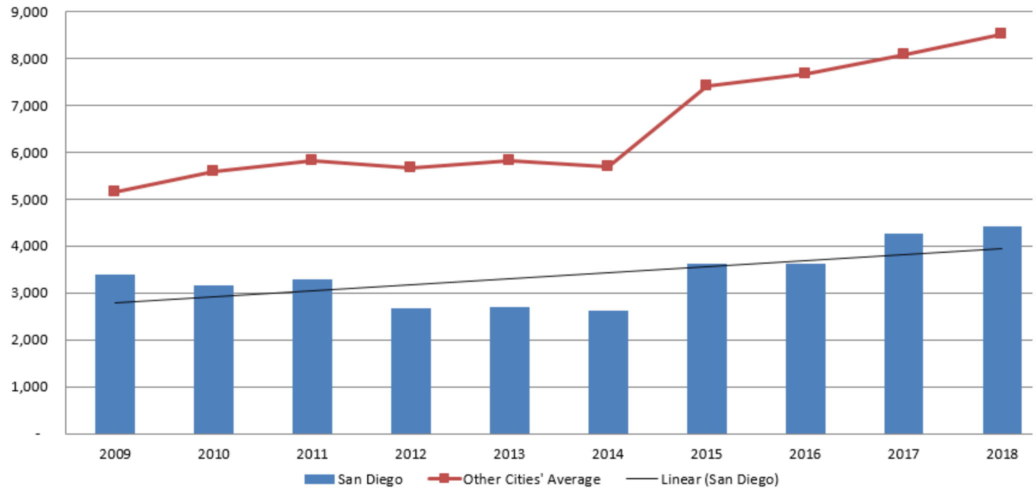
In FY2018, the total long-term liabilities for the City of San Diego were over $6.2 billion. The long-term liabilities per capita were $4,408, which was $1,798 greater than the debt per capita of $1,854. The City's per capita liability burden has increased due to the implementation of GASB 68 and GASB 75 which required the inclusion of Net Pension Liability in the financial statements beginning in FY2015 and OPEB in FY2018.

Exhibit 1:

Primary Government Liabilities per Capita

(Lower is better)

A low ratio suggests suggests less future burden on taxpayers.



Source: City Auditor generated.

San Diego has maintained a level of long-term liabilities well below the average of benchmark cities. Post GASB 68 and GASB 75 implementation, benchmark cities long-term liabilities per capita have been more than San Diego.

Ratio 8: Government Funds Debt Coverage

Formula = Debt Service Expenditures ÷ Noncapital Governmental Funds Expenditures

The government funds debt coverage ratio measures debt service expenditures in relation to operating costs. These expenditures are the annual amount of principal and interest on long-term debt and the amount of interest on short-term debt that a city must pay each year. Debt service expenditures reduce spending flexibility by adding to a city's obligations and can be a major component of fixed costs.

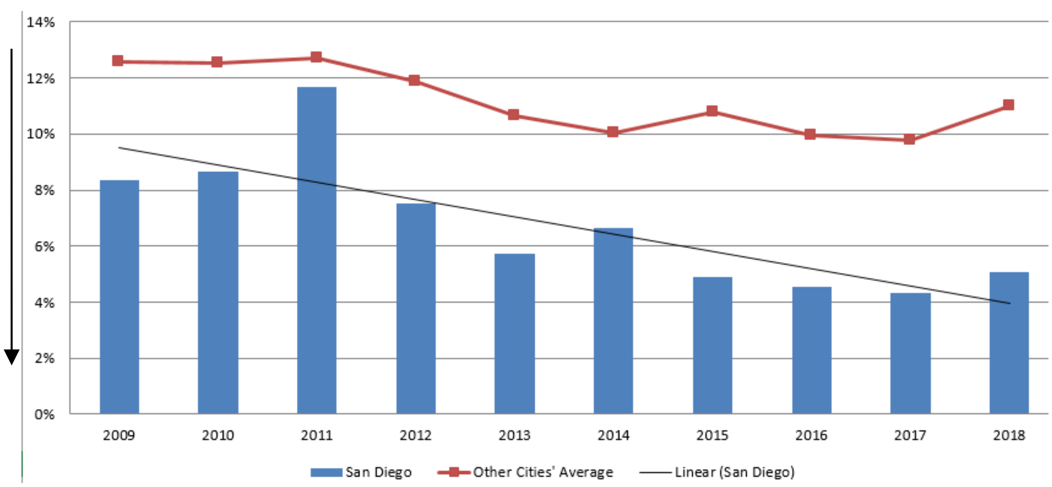
During FY2018, San Diego's debt service expenditures amounted to $97 million or 5.1% of operating expenditures. During the ten-year review period, San Diego's government funds debt coverage ratio ranged from a high of 11.7% in FY2011 to a low of 4.3% in FY2017 and was always below the average of benchmark cities. Despite fluctuations, the ratio shows an overall positive trend.

Exhibit 1:

Government Funds Debt Coverage

(Lower is better)

A low ratio suggests general governmental long-term debt can be more easily repaid.



Source: City Auditor generated.

San Diego's FY2018 ratio was 5.9 percentage points below the average of benchmarked cities and 11.7 percentage points below the highest benchmark ratio. During the last ten-years, San Diego's governmental funds debt coverage ratio was below the average of other cities, indicating greater flexibility for future spending.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1st										**5.1%**
2nd										5.6%
3rd										6.8%
4th										10.4%
5th										10.9%
6th										14.6%
7th										16.8%

Source: City Auditor generated.

The City consistently remained in the top 2 rankings when compared to the other cities during 9 out of the 10 years, ranking number 1 the last four years.

Ratio 9: Enterprise Funds Debt Coverage

Formula = (Enterprise Operating Revenue + Interest Expense) ÷ Interest Expense

The enterprise funds debt coverage ratio indicates the sufficiency of resources available to repay business-type debt. The City uses enterprise funds to account for its Sewer Utility, Water Utility, Airports, Development Services, Environmental Services, Golf Courses, and Recycling. These business-type activities are primarily financed through fees and charges.

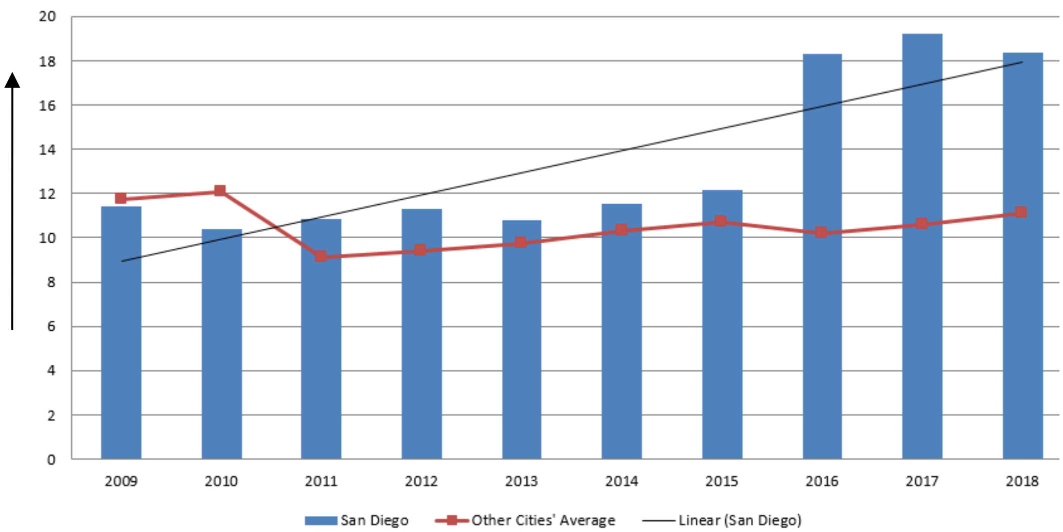
The City of San Diego had maintained a relatively consistent ratio for most of the ten-year period, with a sizable increase in FY2016. San Diego paid $65 million interest expense during FY2018, $26.4 million less than in FY2010.

Exhibit 1:

Enterprise Funds Debt Coverage

(Higher is better)

A high ratio suggests greater resource availability for repaying the debts of enterprise activities as they come due.



Source: City Auditor generated.

San Diego's ratio was relatively consistent with benchmark cities through FY2015 but jumped significantly higher in the most recent three-year period. The San Diego ratios were at 7 to 8 points higher than the average of other cities in FY2016 through FY2018. This suggests that San Diego is in a better position to repay enterprise fund debt than benchmark cities.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1st										**18.3**
2nd										13.9
3rd										13.8
4th										11.8
5th										9.8
6th										8.9
7th										8.4

Source: City Auditor generated.

San Diego was ranked 3rd among benchmark cities during the beginning of the review period and has fluctuated from 1st to 5th ranking through FY2015. San Diego jumped to the top ranking in FY2016 and remained there through FY2018. San Diego was 4.4 above the 2nd ranked city in FY2018.

Ratio 10: Net Change in Capital Assets' Value

Formula = (Ending Net Value of Primary Government Capital Assets − Beginning Net Value) ÷ Beginning Net Value

This ratio measures the change of the net value of capital assets. A high ratio suggests a government is keeping pace, on average, with the aging of its capital assets and replenishing them. A positive percentage change suggests the capital assets are being replenished; a negative number suggests they are being depleted.

One-time spikes due to the addition of large capital projects can be anticipated, but long-term under-performance in this metric can be an indication that the city is under-investing in its infrastructure when compared with other cities. This ratio is not intended to evaluate the capital assets' condition---it is the replenishment of overall assets.

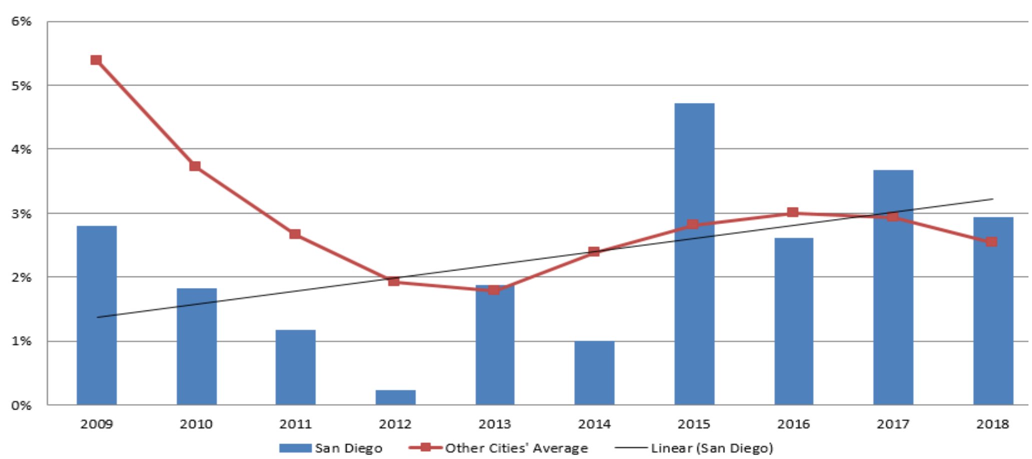
The City's lowest ratio was 0.2% in FY2012. FY2015 was the City's highest ratio at 4.7%, with FY2018 coming in at 2.9% just above the Benchmark Cities average of 2.5%.

Exhibit 1:

Net Change in Capital Assets' Value

(Higher is better)

A high ratio suggests a government is keeping pace, on average, with the aging of its capital assets and replenishing them.



Source: City Auditor generated.

San Diego's ratios were well below benchmark cities average except in 6 of the 10 years, but have been above the average for the most recent two-year period. Overall, the trend for San Diego is moving in a positive direction.

Exhibit 2:

San Diego Ranking to Benchmark Cities

Rank	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1st										5.6%
2nd										4.7%
3rd										3.0%
4th										**2.9%**
5th										2.2%
6th										0.6%
7th										-0.8%

Source: City Auditor generated.

The City of San Diego ranked fourth among the benchmark cities in FY2018 and was ranked 6th in three of the years, making this ratio the least favorable for San Diego's ten-point test.

Pension & Other Post-Employment Benefits Liabilities

Pension liabilities and Other Post-Employment Benefits (OPEB) are not covered as a unique metric in the Mead 10-Point test, but continue to be a focal point of governing bodies and the public. To address these concerns, the Governmental Accounting Standards Board (GASB) has issued new disclosure standards[10] related to both Defined Benefit Pension Plans and Other Post-Employment Benefits (OPEB). Pension and OPEB information in the City of San Diego's FY2018 Comprehensive Annual Financial Report can be found in Notes 12 and 13, as well as in the Required Supplementary Information section.

We will highlight some of the more important metrics regarding Pension Disclosure in this report. The following chart highlights the City of San Diego's pension related metrics. Descriptions of each column follow the chart.

[10] Standards governing Pension Plan disclosures are covered under GASB 67 and 68. Standard 67 covers disclosure requirements for the pension fund entities (Plan) with fiduciary responsibility for managing the investment portfolios, while GASB 68 covers disclosure requirements for government entities (Employer) with pension plans. GASB 67 became effective for plan fiscal years beginning after June 15, 2013, with GASB 68 becoming effective for employers one year later for fiscal years beginning after June 15, 2014.

For OPEB, the GASB Standards are 74 and 75. The effective dates for these Standards are:

- Plans – Effective for fiscal years beginning after June 15, 2016.
- Employers - Effective for fiscal years beginning after June 15, 2017.

Since this review period covers FY2017 and 2018, the Pension GASB has been effective since FY2015, and the OPEB standard was implemented in FY2018. For both Pension and OPEB, the Measurement Date lags the financial statement fiscal year by one year.

City of San Diego Pension Plan Metrics				
Measurement Date Fiscal Year	Investment Rate of Return	Inflation Rate	Net Pension Liability (NPL) (Thousands)	Funded Percentage
2017	7.000%	3.050%	$ 2,522,056	73.5%
2016	7.000%	3.050%	$ 2,650,554	70.4%
2015	7.125%	3.175%	$ 1,713,566	78.8%
2014	7.250%	3.300%	$ 1,535,537	80.4%
City of San Diego OPEB Metrics				
Measurement Date Fiscal Year	Investment Rate of Return	Inflation Rate	Net OPEB Liability (Thousands)	Funded Percentage
2017	6.730%	2.750%	$ 550,444	17.4%

Source: FY2018 CAFR.

Pension and OPEB accounting is complex. Assumptions are used by actuaries to estimate the City's Net Pension and OPEB Liabilities. More conservative assumptions can have a significant impact on these calculations. As such, the data in the above charts should not be used in isolation, but rather in combination to understand the health of the Plans.

- **Investment Rate of Return (IRR):**
  - Commonly referred to as the Discount Rate. A lower percentage is considered more conservative as the investment pool is more likely to meet the set benchmark. SDCERS has been systematically decreasing this metric since the high of 8% prior to the 2008 valuation.
    - To highlight the impact of this assumption:
      - For FY2018 (Measurement Date 2017) If this assumption was 1% lower, the Net Pension Liability would be $3.65 million,
      - If it was 1% higher, it would be $1.59 million.
- **Inflation Rate:**
  - A higher percentage is considered more conservative. Inflation impacts projected future pension costs of the plan.
    - SDCERS had been systematically decreasing this assumption through the FY2016 Measurement Date reporting period.

- **Net Pension Liability:**
  - This represents the unfunded pension liability. (lower is better)
    - This is an outcome of the contributions plus investment returns, less the liabilities based on the actuarial assumptions.
- **Funded Percentage (Plan Fiduciary Net Position as a Percentage of the Total Pension Liability):**
  - Higher percentage indicates a healthier plan. (higher is better)
    - This is a percentage of available plan assets to the total pension liability and is impacted by actuarial assumptions.

Note:

SDCERS' Board exercises its fiduciary responsibility in the administration of the pension plan. This includes reviewing economic assumptions (investment rate, inflation rate, and COLA assumption) annually and demographic assumptions (mortality, rates of retirement, rates of disability, etc.) every five years. Changes to the assumptions may increase or decrease Pension Liabilities and as a result may change the Plan Fiduciary Net Position as a Percentage of the Total Pension Liability.

Contingent Liabilities

Contingent Liabilities[11] information is being provided as there may be significant exposure to the City as a result of these future liabilities. There is no prescribed test to compare these liabilities between agencies as each city faces unique circumstances. These liabilities are not part of the 10-point Mead test.

A contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to a government that will ultimately be resolved when one or more future events occur or fail to occur. Portions of Contingent Liabilities may be accrued, and if so, are included in the 10-point test for Liquidity and Solvency.

The City of San Diego reported the following Contingent Liabilities in the FY2018 Comprehensive Annual Financial Report Note 18:

- Federal & State Grants are included because the granting agencies generally have requirements which must be adhered to. These agencies could request reimbursement for failure to comply.
    - No Estimate (Note disclosure only).
- Litigation & Regulatory disclosure requires number of claims be reported and estimates/accruals be made if determinable:

[11] According to the Governmental Accounting Standards Board (GASB), there are generally three types of note disclosures in the CAFR:

- Those that describe the accounting methods, policies, and choices underlying the amounts in the financial statements.
- Those that provide additional detail about or explanations of the amounts in the financial statements.
- Those that do not meet all the criteria to be recognized in the financial statements (for instance, because the amounts cannot be measured with sufficient reliability).

Most contingent liabilities fall into this third category of GASB required note disclosures. GASB standards make clear that the lists of specific disclosures are "neither all-inclusive nor intended to replace professional judgment" regarding what is necessary to achieve fair presentation. In other words, if a government believes that not disclosing a piece of information would cause the financial statements to be misleading, then it should disclose that information, even if it is not specifically required in the standards. Standards for reporting most contingent liabilities are contained in GASB 62 paragraphs 96 – 113. Pollution Remediation contingent liabilities are covered under GASB 49.

        - 2,121 Claims (28.8% increase from FY2016)
            - Estimates:
                - Not accrued - $0 - $213,382,000 (Note disclosure only), ($21 million decrease from FY2016).
                - Accrued - $201,082,000 ($2.7 million increase from FY2016).

- Storm Water Pollution Remediation – The City is named as a responsible party in the cleanup and/or remediation of the areas listed below:

    - No Reasonable Estimate - (Note disclosure only).
        - Los Peñasquitos Lagoon Sedimentation Total Maximum Daily Load.
        - Chollas Creek Mouth Sediment Investigative Order.
        - Boat Channel at Naval Training Center.
        - SD Bay's Laurel Hawthorne Central and East Embayment (New addition since FY2016).
        - SD Bay adjacent to Tenth Avenue Marine Terminal (New addition since FY2016).
        - SD River (New addition since FY2016).

Commitments

In addition to the Contingent Liabilities, the City of San Diego also discloses Contractual and Regulatory Commitments in Note 17 of the City's Comprehensive Annual Financial Report (CAFR). Contractual commitments are legally binding obligations. Regulatory commitments are not encumbered, but estimates of future costs are disclosed in the footnote. In FY2018 Commitments included the following**:**

- Contractual (Operating & Capital) – Encumbered: $651,465,000 (63% increase from FY2016).
  - General Fund - $10,055,000; (186% increase from FY2016).
  - Non-Governmental Funds - $154,373,000; (70% increase from FY2016).
  - Enterprise Funds - $234,498,000 (53% increase from FY2016).

- Regulatory (separate and distinct from Storm Water Pollution Remediation included in Contingent Liability Note)
  - RWQCB - Municipal Storm Water Permit; Water Quality Improvement Plans (WQIP's) – Estimate.
    - FY2019 – FY2035: $3,128,425,000 (substantially similar to FY2016).
  - CA Dept. of Public Health Compliance Order – Estimate (unidentified portions may be encumbered as part of on-going CIP execution by Public Utilities).
    - FY2019 - FY2021:
      Water System Capital Improvements: $56,900,000 (9% increase from FY2016).

FY2016 Contingency reclassified to a Commitment (See Note 17 in FY2018 CAFR)

- Pt Loma WWTP Modified Permit - Pure Water Program Facilities - Estimate (became a Commitment in FY2017) – As a condition of receiving the permit to avoid upgrading to secondary treatment at Pt. Loma, the City must go forward with the Pure Water Project. Estimated costs are:
    - Sewer Utility: Ph 1 - Sewer Utility; $612,000,000 (53% increase from FY2016).
    - Water Utility: Ph 1 - Water Utility; $865,000,000 (8% increase from FY2016).

Conclusion

The City of San Diego's overall financial condition ranked first among the comparable cities for each of the last eight years. The areas of solvency and debt remain strong when compared to other cities of similar population size and government type. The ratios that indicate recent short-term declines are associated with annual financial performance and governmental activities revenues. These are the areas that require closer monitoring moving forward.

In addition to our financial analysis related to the 10-point test we have included metrics related to Pension, OPEB as well as Commitments and Contingent Liabilities. The rate of liability growth in pensions has stabilized, however the growth in Commitments has increased considerably from Fiscal Year (FY)2016 to FY2018. This was mainly impacted by the reclassification of phase one of the pure water project to a commitment from a contingent liability. We will continue to monitor this in future reports.

Overall, the results are testament of the on-going efforts made by City leaders to implement and maintain strong fiscal policies and of Management for implementation and maintenance of good fiscal practices and controls. Continuous monitoring of financial information is necessary to ensure these policies, practices, and controls are moving the City down a positive fiscal path.

City leaders and employees at all levels need to continue stewardship of the City's finances. Adhering to conservative fiscal policies and practices is an important element of this effort, as is monitoring the City's financial condition going forward. Continually monitoring the City's financial condition raises important questions that policymakers and stakeholders must consider in the decision-making process. Evaluating long-term trends in relation to short-term changes help flag areas in which management may want to provide greater focus. In this manner, continuous financial analysis helps ensure the City's decisions are fully informed and financially responsible.

Appendix A: Objectives, Scope, and Methodology

Objectives

In accordance with the Office of the City Auditor's Fiscal Year (FY)2020 Audit Work Plan, we conducted a performance audit of the City of San Diego's financial condition. Specifically, our audit objective was to examine the City's financial well-being in four areas—financial position, revenues, debt, and capital assets—by calculating 10 ratios, analyzing trends in the City's financial data over a 10-year period, and comparing the results to other cities of similar size and government type.

Scope and Methodology

To address our audit objective, we selected the modified 10-point test for assessing financial condition for local governments, as presented by Dean M. Mead, Research Manager at the Governmental Accounting Standards Board (GASB). This method incorporates both short-term and long-term aspects of a city's financial well-being while being relatively simple, straightforward, and easy to use. This is because the method relies primarily on audited and reliable financial data published in the city's Comprehensive Annual Financial Reports (CAFRs).[12] This method also incorporates financial reporting changes made as a result of GASB Statement 34, which required governments to publish full accrual, government-wide information. This change made longer-run and more complete information available, which allows for the assessment of a more comprehensive concept of financial health.

The modified 10-point test is based on 10 financial ratios, which are used as indicators for several aspects of the City's financial health. The ratios and the primary sources for the figures used to calculate them are listed in the following table.

[12] CAFRs used for San Diego and the comparison cities were obtained from their respective websites.

Ratio#	Ratio Description	CAFR Source(s)
1	Short-run Financial Position: Unreserved General Fund Balance ÷ General Fund Revenues.	Governmental Funds Balance Sheet; Governmental Funds Statement of Revenues, Expenditures, and Changes in Fund Balances
2	Liquidity: General Fund Cash and Investments ÷ (General Fund Liabilities − General Fund Deferred Revenues).	Governmental Funds Balance Sheet
3	Financial Performance: Change in Governmental Activities Net Assets ÷ Total Governmental Activities Net Assets.	Government-Wide Statement of Activities
4	Solvency: (Primary Government Liabilities − Deferred Revenues) ÷ Primary Government Revenues	Government-Wide Statement of Net Assets and Statement of Activities
5	Primary Government Revenues: (Primary Government Operating Grants and Contributions + Unrestricted Aid) ÷ Total Primary Government Revenues.	Government-Wide Statement of Activities
6	Governmental Activities Revenues: [Net (Expense) Revenue for Governmental Activities ÷ Total Governmental Activities Expenses] × −1.	Government-Wide Statement of Activities
7	Primary Government Debt Burden: Total Outstanding Debt for the Primary Government ÷ Population.	Long-Term Liabilities Note Disclosure and Statistical Section
8	Government Funds Debt Coverage: Debt Service ÷ Noncapital Governmental Funds Expenditures.	Governmental Funds Balance Sheet or Statistical Section
9	Enterprise Funds Debt Coverage: (Enterprise Funds Operating Revenue + Interest Expense) ÷ Interest Expense.	Proprietary Funds Statement of Revenues, Expenses, and Changes in Fund Net Assets
10	Capital Assets: (Ending Net Value of Primary Government Capital Assets − Beginning Net Value) ÷ Beginning Net Value.	Capital Assets Note Disclosure

Source: Public Financial Management – Chapter 15.

To make the financial ratios of the 10-point test most meaningful, Mead suggested that the ratios needed the context provided by a comparison with prior years and with other, similar governments. Therefore, we calculated the 10 financial ratios for the City of San Diego over a period of 10 fiscal years (2009 through 2018), and calculated the same ratios for six other cities over the same period of time.

To select the benchmark cities, Mead suggested three characteristics as a basis for comparison:

1. Government type;
2. Geographic region; and
3. Size (in terms of either financial activity, population, or both).

We selected benchmark cities based on government type and size. Since San Diego is the eighth largest city in the United States, selecting only benchmark cities in the same geographic region, or even within the state of California, would have made the comparison and resulting analysis less meaningful. For example, cities with a similar population size[13] tend to face similar challenges and service demands, which have a direct bearing on financial condition.

In this report we eliminated Philadelphia due to dis-similar government type as it's a City/County. We replaced it with Los Angeles as it is larger than San Diego as was Philadelphia and is in closer proximity. We also eliminated Dallas due to its location and poor performance, and substituted it with Seattle which is smaller, but more similar to San Diego in services. The following table lists the cities in the comparison group along with their estimated population size as of July 1, 2018.

[13] The only city in California with similar population size was San Jose, which was included in the comparison group. Also included was Los Angeles with 3,990,456 in population. San Francisco with 883,305 is closer than Seattle however it's a City/County, and Fresno and Sacramento have just over 500,000 in population each making them just over one third the size of San Diego.

City Name	Population Estimate (2016)
Los Angeles	3,990,456
Phoenix	1,660,272
San Antonio	1,532,233
San Diego	**1,425,976**
San Jose	1,030,119
Austin	964,254
Seattle	744,955

Source: US Census Bureau, Population Division.

After calculating the 10 financial ratios for San Diego and the benchmark cities from CAFR data, we compared San Diego's results to the benchmark cities' average and plotted these on a graph. We also ranked results for all cities in each of the 10 ratios and across all 10 years. We developed our conclusions based on this comparative analysis. Finally, we calculated quartile ranges for each individual ratio based on all of the cities' ratio values. We then assigned scores to each city based on its results in comparison to the other cities. We did this for each city in every ratio across all 10 years. In accordance with the modified 10-point test, we awarded two points for each ratio that fell in the top quartile (top 25 percent) of the comparison group. One point was given for each in the second quartile, and no points for a ratio in the third quartile. A point was subtracted for a ratio in the lowest quartile. We used the points and the resulting cumulative score to rate San Diego's financial condition relative to the benchmark cities. This relative rating is based upon the following scoring table:

Overall Score	Rating Relative to Other Cities
10 to 20	Among the Best
5 to 9	Better than Most
0 to 4	About Average
-5 to -1	Worse than Most
-10 to -6	Among the Worst

Source: Public Financial Management – Chapter 15.

Disclaimers Analyzing financial ratios provides a broad assessment of San Diego's financial condition, but it is important to recognize strengths and limitations to this sort of analysis. The table below highlights some of the strengths and limitations of our method.

Strengths	Limitations
Comparative data compiled under consistent accounting principles and audited under Government Auditing Standards.	Analysis provides a broad overview rather than detailed analysis.
Ratios developed independent of management and provides an independent view of the City's finances.	Excludes information on level and quality of services and infrastructure as well as external factors, such as demographic and economic trends, that may affect City finances.
The City's results are contextualized by comparison to cities of similar size.	Provides historical analysis rather than projections of future condition.
The City's results are contextualized by comparison over a 10-year period.	Results are a relative comparison, but do not provide the optimal ratio value a city should strive for.

Source: City Auditor generated.

All underlying financial information in this audit originates from the City's CAFRs. Accordingly, we relied on the audit work performed by the City's external financial auditors. We therefore did not audit the accuracy of source documents or the reliability of the data in computer-based systems.

Our assessment of internal controls over financial reporting was limited to a review of the Independent Auditor's Report in the benchmark city's Comprehensive Annual Financial Reports and the opinions expressed therein. Based on the opinions, the respective financial statements are presented fairly in all material respects.

Our review of data was not intended to give absolute assurance that all information was free from error. Rather, our intent was to provide reasonable assurance that the reported information presented a fair picture of the City's financial health. In addition, while this report offers financial highlights, it does not thoroughly determine the reasons for negative or positive performance. More in-depth analysis would be needed to provide such explanations.

This report was independently developed by the Office of the City Auditor and is intended for the general public as a high-level report. This report is the result of a performance audit, and was not part of the annual audit of the City’s financial statements. Expressions of opinion in the report are not intended to guide prospective investors in securities offered by the City, and no decision to invest in such securities should be made without referencing the City’s audited CAFRs and official disclosure documents relating to a specific security.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix B: City Departments Involved in Managing Financial Condition

How Does the City Manage Its Financial Condition?

The City's financial condition is multi-faceted and depends on the work performed by the departments shown below which are overseen by the Chief Financial Officer (CFO):

Department of Finance:

- **Budgeting**
- **Fiscal Consulting**
- **Financial Reporting**
- **Disbursements**
- **Payroll**
- **Internal Controls**

The Department of Finance provides fiscal services to the Mayor and serves as an internal fiscal consultant to other City departments. They prepare the proposed and annual budgets in accordance with the City Charter. During the fiscal year, they monitor the City's revenues and expenditures, oversee budget transfers and adjustments, and review requests for City Council and Mayoral Actions for both the operating budget and the Capital Improvements Program (CIP). In addition, the Department develops and updates the Mayor's Five-Year Financial Outlook.

The Department of Finance is also responsible for the preparation of the Comprehensive Annual Financial Report (CAFR), which includes an accounting of all City funds and its component units. The CAFR contains note disclosures that provide additional financial information and are necessary to fully understand the City's financial position. The Department of Finance performs the general accounting and financial reporting function for the City. The Department of Finance is also responsible for payment services, including payroll processing and centralized processing for all vendor payments. In addition, the Department of Finance oversees the Internal Controls Section, which is mainly responsible for implementing and monitoring internal controls over financial reporting and operations.

City Treasurer: • **Receivables** • **Banking** • **Investments**	The Office of the City Treasurer is responsible for the receipt and custody of all City revenue, banking, tax administration, parking administration, parking meter operations, collection of delinquent accounts, and accounting for these funds. The City Treasurer is also responsible for the investment of all operating and capital improvement funds, including the reinvestment of debt proceeds of the City and its affiliated agencies.
Debt Management: • **Financing**	The Debt Management Department conducts planning, structuring, and issuance activities for all City financings to fund cash flow needs and to provide funds for capital projects, essential equipment, and vehicles. The Department monitors outstanding bond issuances for refunding opportunities and performs, coordinates, and monitors certain post-issuance administrative functions.
Risk Management: • **Financial** • **Self-Insurance**	The Risk Management Department seeks to prevent, control, and minimize the City's financial risk while providing optimum services to the City's employees and its citizens through the centralized administration of healthcare, safety, loss control, employee benefit, and other risk management programs.
Independent Budget Analyst: • **Budget and Policy Analysis**	In addition to the departments overseen by the CFO, the Office of the Independent Budget Analyst (IBA) assists the City Council with budgetary inquiries and in the making of budgetary decisions. The IBA provides information, analyses, and recommendations throughout the annual budget process, as well as for all financial and policy items submitted throughout the year for City Council, Council Committee, and Housing Authority consideration. Each fiscal year, the IBA reviews and evaluates the Mayor's Proposed Budget and Five-Year Financial Outlook, issuing reports that provide analysis and recommendations for City Council consideration.

Appendix C: Information Related to the City's Financial Statements

Comprehensive Annual Financial Reports (CAFRs)

The financial data used to calculate the ratios in this report originate from CAFRs from the City of San Diego and the benchmark cities. A CAFR is the official annual report of a state or local government. It includes introductory materials (such as a letter of transmittal and auditors' report), financial statements, supporting notes, supplementary schedules, and statistical data. Information from the annual financial reports provides consistent, reliable data because it conforms to generally accepted accounting principles and is audited under generally accepted government auditing standards. San Diego CAFRs used in this assessment were independently audited by Macias Gini & O'Connell LLP (MGO) Certified Public Accountants, and, in their opinion, the financial statements were fairly presented in all material respects.

Basic Financial Statements

The City's basic financial statements include three components:

1. Government-wide financial statements;
2. Fund financial statements; and
3. Notes to the financial statements.

1. Government-wide Financial Statements

The focus of the government-wide financial statements is reporting the operating results and financial position of the government as an economic entity. These statements are intended to report the City's operational accountability to its readers, giving information about the probable medium and long-term effects of past decisions on the City's financial position.

The statement of net position presents information on all of the City's assets, deferred outflows of resources, liabilities, and deferred inflows of resources, with the residual amount reported as net position. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of the City is improving or deteriorating.

The statement of activities presents information showing changes in the City's net position during the fiscal year. All changes in net position are reported when the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. The focus is on both gross and net costs of City functions, which are supported by general revenues. This statement also distinguishes functions of the City that are principally supported by taxes and intergovernmental revenues (governmental activities) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (business-type activities). The governmental activities and business-type activities together make up the primary government.

Governmental Activities
General Government and Support
Public Safety - Police
Public Safety - Fire, Life Safety, and Homeland Security
Parks, Recreation, Culture, and Leisure
Transportation
Sanitation and Health
Neighborhood Services
Debt - Cost of Issuance and Interest on Debt Service

Business-Type Activities
Sewer Utility
Water Utility
Airports
Development Services
Environmental Services
Golf Course
Recycling
San Diego Convention Center Corporation

Source: City of San Diego FY2018 CAFR.

2. Fund Financial Statements

The focus of the fund financial statements is on reporting of a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. All funds of the City can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements.

Proprietary fund statements provide the same type of information as the government-wide financial statements, only in more detail. The proprietary funds financial statements provide separate information for the Sewer and Water Utility funds, which are considered to be major funds of the City. Data for the non-major proprietary funds are combined into a single, aggregated presentation, and the internal service funds are combined into a single, aggregated presentation as well.

Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the City's operations. Fiduciary funds were therefore not included in the ratio analysis.

3. Notes to the Financial Statements

The notes to the basic financial statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

GASB Changes Related to Pension Reporting

The Government Accounting Standards Board (GASB) has issued at least three statements that will address how cities report postemployment benefits in the future.[14] According to the Department of Finance, under guidelines in effect through FY2018, cities were required to include in the notes to the financial statements significant disclosures related to other postemployment benefit (OPEB) obligations, including the amount of the unfunded accrued liability as calculated by an actuary.

For example, the OPEB's unfunded actuarial accrued liability (UAAL) for San Diego of $538 million is disclosed in Note 12 of the FY2016 CAFR. However, according to the City Comptroller, prior to FY2017, the GASB standards did not allow inclusion of the UAAL as a long-term liability in the financial statements. Rather, GASB required that only the cumulative underfunding amount of the annual required contribution be reported as liabilities in the financial statements.

Under the new GASB standards, cities are now required to report the OPEB liabilities, as defined by the standards, in the government-wide statement of net position and in the statement of net position of proprietary funds. These changes impact the total liabilities reported by cities in their financial statements.

[14] GASB Statement Number 73, Accounting and Financial Reporting for Pensions and Related Assets That Are not with the Scope of Statement 68, and Amendments to Certain Provisions of Statements 67 and 68.

GASB Statement 74, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans.

GASB Statement 75, Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions.

THE CITY OF SAN DIEGO

MEMORANDUM

DATE: December 2, 2019

TO: Kyle Elser, Interim City Auditor

FROM: Rolando Charvel, Chief Financial Officer

SUBJECT: Management Response to Performance Audit of the City's Financial Condition

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The purpose of this memorandum is to provide Management's response to the Audit Report entitled "Performance Audit of the City's Financial Condition." The City Auditor's Report focuses on activity from the City's Comprehensive Annual Financial Reports (CAFR) for Fiscal Years 2017 and 2018, tracking results over a ten-year period, with comparative data from cities with similar government type and population size.

As the report indicates, the City's financial indicators continue to outperform comparative cities, with San Diego being the highest overall ranked among the seven cities included in the report. The results of the audit are consistent with the City's strong credit ratings. The City maintains ratings in the second highest rating category from three of the national credit rating agencies. These include "AA" ratings from Standard and Poor's and Fitch Ratings and Aa2 from Moody's Investors Service.

The Mayor and Council have maintained sound financial policies and practices over the years, allowing the City to continue to build upon its strong financial standing. In addition to maintaining cash reserves to protect the City from economic downturns, unforeseen events and increases in pension costs, the City adopts a structurally balanced budget each year, maintains strong expenditure controls, conducts long-term financial planning and adheres to responsible and equitable debt practices.

It is important to note that the metrics included in this report are based on formulas that provide a high-level and limited view of each city's financial condition. A more complete financial assessment can only be achieved through a careful review and understanding of each city's annual financial statements and note disclosures. Even when comparing cities of similar population, there may be significant differences between them, including different functions performed for their residents, differences in socioeconomic, political and regulatory environments in addition to opportunities and limitations afforded by their geographic location and natural environment. There are also differences relating to revenue or debt raising ability among local agencies in California compared to localities in other

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Kyle Elser, Interim City Auditor
December 2, 2019

states. Similarly, the assumptions used to measure and fund Pension and Other Post Employment liabilities can vary significantly between cities.

Rolando Charvel
Chief Financial Officer

cc: Aimee Faucett, Chief of Staff, Office of the Mayor
Kris Michell, Chief Operating Officer
Andrea Tevlin, Independent Budget Analyst
Ronald H. Villa, Assistant Chief Operating Officer
Almis Udrys, Chief of Innovation & Policy, Office of the Mayor
Jessica Lawrence, Director of Policy & Council Affairs, Office of the Mayor
Tracy McCraner, Department of Finance Director and City Comptroller
Lakshmi Kommi, Director, Debt Management Department
Scott Clark, Deputy Director, Department of Finance
Chris Kime, Principal Performance Auditor, Office of the City Auditor