The "Kroll Report"

Report of the Audit Committee of the City of San Diego
August 8, 2006

Summary

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Introduction

The City of San Diego is among the handful of local governments in the U.S. that are the most notorious examples of deeply flawed financial management related to its retiree obligations. I know of no other situation that has generated more legal action, indictments, and controversy related to these issues.

In August 2006 the "Kroll Report" was published that analyzed what happened in the City of San Diego. It is the most comprehensive and competent analysis of issues related to the mismanagement of the funding of retiree benefits I know of - by far.

I believe there are some striking similarities between the City of San Diego and Mendocino County regarding some of these issues. For example, I find much of the section "Underlying Causes" on page 3 to be highly relevant to our County.

However, there are also a number of very significant differences. These include (but are not limited to):

- The City is by far a much larger and complex financial and political entity.
- Some individuals in the City's situation obtained very significant personal financial benefits from wrongdoing; I see no indication anything of that sort occurred in Mendocino County.
- The City borrowed hundreds of millions of dollars by selling Municipal Bonds (for water and wastewater projects and attempted to sell Bonds to build a new professional baseball park) <u>after</u> the main allegations of wrongdoing related to the pension fund occurred - this was a major focus of allegations of "securities fraud". Mendocino County didn't sell any Bonds after the 2002 Pension Obligation Bonds.
- Although issues related to the financial management of the City's retiree benefits is the major topic of the Kroll Report, there were also very significant issues regarding finances and the City's Wastewater Department. I don't see any other major issues in Mendocino County outside the financial management of the County's retirement benefits.

The Kroll Report alledged that laws were broken and felonies were committed. In fact many of the legal actions brought against individuals were eventually dismissed - but not all. I make no such assertions regarding the financial management of retirement benefits in Mendocino County. But I do believe there are several interesting parallels in the two stories.

The Kroll Report

The main body of the Kroll Report[1] is 266 pages. Its attachments are an additional 215 pages. There are hundreds of pages of transcriptions of around 50 interviews the Audit Committee conducted. The Report has over 1300 footnotes, some of which themselves are quite extensive. The full report was read for this paper (some parts admittedly were mostly skimmed over - such as issues regarding the City's wastewater financing). Some of the appendices and footnotes were as well.

I've read lots of reports in my career; the Kroll Report is one of the most extensive and best.

This information in the rest of this section summarizes the findings of the Kroll Report as expressed in that report's Introduction, Executive Summary, and some of the more detailed sections of the Report.[2]

In September 2003 a member of the San Diego City Employees Retirement System Retirement Board uncovered evidence that the City's annual financial statements might have contained very serious errors in data and disclosures and reported this information to the City Council in open session. This began an increasingly intense series of events that came to a head when the City's outside auditors refused to issue a "clean" audit report.

In February 2005 the City Council voted to retain Kroll, Inc. a major international corporate and governmental risk management firm. Essentially, Kroll was asked to "get to the bottom" of the City's crisis. The City and Kroll agreed to create an Independent Audit Committee for the City composed of Arthur Leavitt, the former Chairman of the SEC, Lynn Turner, former Chief Accountant for the SEC, and Tony Dahlberg, Kroll Managing Director in charge of Forensic Accounting and Litigation Consulting for the West Coast. They were completely independent of any City authority and were provided with significant resources to conduct their investigation.

The investigation took well more than a year, and the Audit Committee's Report - known as the "Kroll Report" - was issued in August 2006.

A. <u>Timeline</u>

The narrative in this timeline is mostly derived from the introduction in the Kroll Report.

The City of San Diego (the "City") adopted pension funding and benefit plans in 1996 and 2002 that deliberately under-funded its pension fund by deferring a portion of the City's contributions to future years. Pension benefits were increased, but the City wound up paying less than what a "straight-forward" actuarial analysis would have determined. Two big problems were created. First, the City's unfunded pension liability grew significantly. Second, the City's public financial statements and disclosures didn't properly disclose this problem.

In the fall of 2003 a member of the Retirement Board made public her discovery of several accounting and disclosure errors that suggested the City's financial statements could contain significant misstatements. This led to a series of increasingly intense internal investigations by the City that uncovered many problems far beyond those identified by the whistleblower.

[1] *<u>Report of the Audit Committee of the City of San Diego</u>*, (the "Kroll Report") Levitt Jr., Turner, Dahlberg, Kroll - Willkie Farr & Gallagher, August 8, 2006 - available at http://www.sandiego.gov/mayor/news/kroll.shtml

[2] Kroll, pp 1-7

But then things got considerably more intense. Both the Securities and Exchange Commission ("SEC") and the US Attorney's Office initiated investigations in 2004. Among other things a federal grand jury indicted five Retirement System officials with a range of criminal charges. (However, a federal judge dismissed these charges the day this summary was written - April 7, 2010. News reports suggest this ruling is likely to be appealed.)

The State of California acting through the San Diego District Attorney brought similar charges, including allegations that officials used their positions for financial gain. (One of those charges - felony conflict of interest - was decided against the defendants in the trial court and appellate court. However, the State Supreme Court reversed the lower courts and dismissed the charges for five of the six defendants finding a statutory exception for members of the Pension Board from the type of conflict of interest cited. The sixth defendant's conviction was not overturned because he received a specific benefit based on his vote on the Pension Board.)

A new City Attorney began a highly visible investigation shortly after he took office in November 2004.

But the major turning point in how the City itself confronted these problems occurred in early 2005. The City's new outside auditors refused to issue an audit report because, in its judgment, there were too many allegations of financial wrong-doing and obfuscation that had not been resolved. This immediately blocked the City's access to critical financing. The crisis came to a boiling point.

The outside auditors demanded that a completely independent investigation be conducted. The City then contracted with Kroll Security Group ("Kroll") as described on page 1.

Quite a number of civil complaints have been filed in the San Diego Superior Court among various parties regarding a wide range of issues related to "all this". These suits involve the City, the Retirement system, former and current officials of both, retirees, and many others.

B. <u>Failures</u>

The Executive Summary of the Kroll Report identified a number of general and specific "failures" on the part of the City and the Retirement System. The Summary begins:

> *Evidence made available in this investigation demonstrates numerous failures of San Diego City government - on the part of government officials and outside professional "gatekeepers" alike - to conform to the law, to adhere to principles of sound governance and financial reporting, and to protect the financial integrity of the City's pension system and thereby the welfare of the City itself.... The evidence demonstrates not mere negligence, but deliberate disregard for the law, disregard for fiduciary responsibility, and disregard for the financial welfare of the City's residents over an extended period of time[3].*

Among the specific "failures" listed in the Executive Summary:

- Pension Fund - failed to prepare for completely foreseeable financial challenges, reckless & wrongful mismanagement
- Pension Board violated fiduciary responsibility by reducing flow of funds to Pension Fund to benefit City without creating a compensating benefit for the pension system itself.
- Use of so called "Excess Earnings" to pay for retiree healthcare and failure to disclose significant negative effects of so doing.

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[3] Kroll, p 1

- Pension Board made false and misleading statements to disguise underfunding.
- Numerous violations of Federal Securities Laws - obtained money from investors through false financial statements and disclosures.
- Fraudulent City misrepresentation to investors claiming City making contributions to pension fund at actuarially determined rates when in fact it was not.
- City falsely claiming it was using an "excellent method" of pension funding when it wasn't in accord with legal requirements.
- Failed to disclose conflicts of interest on pension board that threatened pension financial soundness and increased pension board member benefits.

C. Underlying Causes

The Kroll Report makes this high-level summary statement:

> *While this conduct was plainly unlawful, the evidence does not demonstrate that City officials set out with the objective of defying legal mandates. Rather, the evidence suggests that at root San Diego City officials fell prey to the same type of corruption of financial management and reporting that afflicted municipalities such as Orange County and such private sector companies as Enron, HealthSouth, and any number of other public corporations. That is, San Diego officials cultivated and accepted a culture of financial management and reporting premised upon non-transparency, obfuscation, and denial of fiscal reality.*[4]

Other findings:

- Officials gave expedience a higher priority than fiscal responsibility and came to view the law as an impediment to be circumvented through artful manipulation
- Deplorable lack of accountability and organization
- No one viewing him/herself as accountable for accuracy of financial statements
- No one making sure information in audits was correct
- Financial statements false because of incompetence and neglect
- Outside professionals failing to perform their independent duty

D. Inadequate Internal Attempts to Confront Issues

The Audit Committee made this observation about a series of efforts organized from 2003 into 2005 by the City and Retirement System to grapple with the emerging crisis:

> *Along the way, special committees were formed, reports issued, and public inquiry made, all creating an appearance of efforts to come to grips with the pension and other problems. However, these efforts too were compromised by the prevailing culture of political expedience. ...*
>
> *Only when the City's new (outside independent) auditor ... refused to issue an audit report on the City's financial statements - thereby blocking City access to*

4 Kroll, p 3

the municipal bond markets and accelerating the City's need to confront its looming financial crisis - did City officials begin to face reality. Even then, early investigative efforts were haphazard, poorly structured, and encountered steadfast resistance from various pockets of City government. Among those resisting (after the refusal to issue an audit report) ... was not the City Council which, while acting too late, did ultimately recognize the need for a thorough and independent investigation as a critical step out of the City's fiscal woes.[5]

The Audit Committee then pointed out that the City Attorney and Pension Board both offered "steadfast resistance to the investigation".

An early "Blue Ribbon Committee" with citizen experts was formed to examine the situation and make recommendations. The Audit Committee states the local business leader who headed the committee tried his best. But once City officials saw the seriousness of the Committee's efforts, the officials "undertook a concerted effort to water down the vividness of (the Committee's) determinations.

At some point proposals being made by some City and Pension Officials for the City to borrow money by selling Pension Obligation Bonds to overcome some of the effects of what had happened. However, the Audit Committee made this comment regarding this concept:

Even as to the $1.4 billion pension deficit, City government does not seem prepared to face up to fiscal reality. It has been suggested that the City address the deficit through the issuance of pension obligation bonds which would use borrowings from investors to increase pension assets, but which would not reduce the City's underlying obligation to fund the pension liability. In so doing, the City would continue to push off the funding of these obligations to future generations of taxpayers while avoiding the difficult fiscal decisions that must be made.[6]

E. Needed Reform

The Audit Committee began its "Needed Reform" section of its Executive Summary:

At the most basic level, fundamental reform is needed in the process by which the City budgets, monitors, and reports its finances.

Foremost, accountability for fiscal decision-making and disclosure must be built into the City's financial reporting system.[7]

The Audit Committee provided a number of specific recommendations, including:

- Greatly strengthen the Chief Financial Officer position
- City, Pension, and other related officials should sign statements of personal responsibility for establishing and maintaining an effective system of internal control over financial reporting, and such statements should be included in annual financial reports.
- Audit Committee should be organized - majority would be outsiders with "significant financial expertise in accounting, auditing, and financial reporting." Audit committee would hire and direct outside City auditor in production of annual audited financial statements, and have authority to

[5] Kroll, p 4 - 5

[6] Kroll, p 5

[7] Kroll, p 6

inquire into all aspects of City finances, including control and reporting. (This way of organizing Audit Committees is common practice in private sector organizations.)

- Pension Board must be more independent, accountable, and transparent. The Pension Board Chair and Chief Administrative Officer should sign statements of personal responsibility as described above
- Significant reform of budgeting and planning - five year financial plan including items not in annual budget such as "anticipated capital expenditures, deferred maintenance, debt payments, other major contractual expenditures, and expected major sources of revenues." Year end budget report should identify and explain significant variances - written explanations by department heads should be in annual budget report.
- Create position of "Monitor" - "oversight responsibility as to all aspects of the [City's] system of budget, finance, and internal control over financial reporting." Also evaluates compliance with law and regulations that have been violated regarding pension funding, financial reporting and disclosure, and implementation of remedial actions to reform government.