

Audit Committee of the City of San Diego

August 5, 2005

Honorable Mayor Toni Atkins
Members of the City Council
City of San Diego
202 C Street, Suite 900
San Diego, CA 92101

Re: Audit Committee Update

Honorable Mayor & Councilmembers:

We write to update you on the status of our investigative work, what we have accomplished so far, and what remains to be done.

Progress to Date

To date, we have identified 149 allegations relating to potential illegal acts and other misconduct by City officials requiring investigation. This identification is the result of issues raised by Diann Shipione, correspondence from KPMG, the work undertaken by Vinson & Elkins (“V&E”), public charges by the City Attorney, queries made by the Securities and Exchange Commission (“SEC”), and our own review of documents. As to each instance of potential illegal acts and other misconduct, we must be in a position to do four things. First, we must obtain a complete understanding of the investigative procedures used by V&E and the City Attorney. Second, we must separately evaluate the thoroughness and adequacy of those procedures. Third, we must undertake a substantive assessment of their conclusions as to the extent to which illegal acts have, or have not, taken place. Fourth, to the extent they have not adequately investigated an allegation, we must do so ourselves.

The main challenge to date has been getting the work into a format so that the investigative procedures may be understood and evaluated. As to the City Attorney, that office has been uncooperative. We requested documentation supporting the City Attorney’s charges of illegal acts in March. We followed that request with repeated requests and then, on May 20 and July 27, written requests. To date, the City Attorney has not responded with a complete production of the documentation or other information sought by those requests. Insofar as there appear to be significant instances in which the City Attorney’s analysis is inconsistent with that of V&E, the City Attorney’s lack of cooperation with our investigation is significantly hampering our efforts.

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As to V&E, much more progress has been made in the past three months. Thanks to V&E's cooperation, we have met extensively with V&E and been able to distill the 149 allegations into 17 substantive subjects. As to each, we have requested that V&E complete a summary memorandum and separate collection of key documentation so that the documentary predicate for V&E's substantive conclusions may be understood and evaluated.

We are pleased to see that V&E, as set forth in its letter of August 5th, has reported that its work is "substantially complete." That enables us to move forward with the process of evaluation, assessment and completion of our own independent findings, conclusions and report. Our report may or may not arrive at the same findings or conclusions reached by others who have issued reports.

Substantive Work Plan

To assist in that evaluation and assessment, and completion of our investigational report we have formulated a detailed work plan setting forth precisely those steps that need to be undertaken and precisely how we plan to undertake them. We have met with the City's auditors from KPMG and presented to them a draft of our work plan, V&E's memoranda, and supporting work product. The preliminary feedback from KPMG has been favorable to our proposed approach. We believe the work plan, upon implementation, will adequately address the issues that KPMG has understandably raised with regard to the investigative work undertaken.

As part of that work plan, we will need to do the following –

- Examine and evaluate the potential significance of documentation not reviewed or evaluated by V&E.
- Commence additional investigation into areas where V&E's investigative procedures are unclear.
- Investigate newly-available evidence not made available to V&E at the time of its work.
- Investigate new issues raised by the SEC subsequent to V&E's examination of documents and interviews, including but not limited to Metropolitan Waste Water.
- Evaluate the extent to which the 92 witnesses substantively interviewed need to be reinterviewed in order to explore aspects of potential illegal acts not already addressed.

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- Analyze in greater depth the accounting, actuarial, and disclosure issues involved, as well as questions regarding individual culpability.
- Reconcile conflicting analysis and conclusions by V&E and the City Attorney, arriving at our own independent conclusions.

Cooperation with the SEC and the U.S. Attorney

Critical to this effort is cooperation with the SEC and the U.S. Attorney and significant effort has been directed to that objective. We met with representatives of the SEC yesterday, discussed our analysis and preliminary evaluation of V&E's work, and reviewed with the SEC representatives our plans for the completion of a thorough and independent investigation. A similar effort is under way with regard to the U.S. Attorney.

In addition, we have been working to bring the City into compliance with regard to a number of outstanding subpoenas and document requests from both the SEC and the U.S. Attorney. To date, substantially all City employees and elected officials have completed certifications as requested, subject to additional verification by the Audit Committee working in conjunction with the City. We have identified approximately 400 employees or elected officials as to whom additional documents will be forthcoming. In the meantime, the SEC has requested additional documents related to the cost of service for the Metropolitan Wastewater System. The U.S. Attorney has also issued an additional subpoena requesting documents concerning compensation and benefits related to certain employees of the San Diego City Employees Retirement System ("SDCERS"). We estimate that it will take several additional weeks for the City's production of documents to be complete. Involved in that effort are the City Attorney, the City Manager, V&E, Cooley Godward LLP, and the Audit Committee.

Remediation Efforts

While a complete plan of remediation must await our investigative conclusions, several steps in that direction have already taken place. These include the termination of specified employees and the development of stronger internal controls over financial reporting. As further remediation, we have earlier expressed our view that the SDCERS board will need to engage a new actuary.

Attorney-Client Privileged Documents

While we understand everyone is tired of this issue, we must caution that our investigative work cannot be brought to conclusion absent a waiver by the SDCERS board of the attorney-client privilege. Unfortunately, the SDCERS board's failure to

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provide that information is both delaying the process and exacerbating the cost. It is foreseeable that, upon waiver of the privilege and receipt of the information, additional research will need to be undertaken, documents already examined will need to be reexamined, and witnesses already interviewed will need to be reinterviewed. The SDCERS board's recalcitrance is, obviously, exceedingly unfortunate.

Cost and Completion Date

We have earlier estimated that the cost of this investigation will average approximately \$800,000 per month. That continues to be our estimate. While that may turn out to be the average, though, we are now beginning a period of particularly intensive activity and we would expect the monthly cost over the next two or three months to be higher than that and then to drop off thereafter. We also caution that our estimates have been premised upon the expectation of cooperation by the City Attorney and the SDCERS board. To date, neither has cooperated.

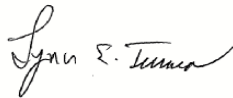
Continued lack of cooperation or identification of additional issues requiring investigation can only be expected to significantly drive up the cost. Should the City Attorney make additional allegations of misconduct by city officials, those will also need to be investigated which would be expected to increase the cost further. However, it is important that a thorough and complete investigation be completed including appropriate action taken with respect to any individuals culpable of misconduct.

As to our completion date, we continue to believe that we can bring this effort to its conclusion by year end if not before.

Very truly yours,



Arthur Levitt



Lynn E. Turner



Troy A. Dahlberg