

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN
ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

The Honorable Mayor and
Members of City Council
of the City of Costa Mesa
Costa Mesa, California

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Governmental Auditing Standards issued by Comptroller General of the United States, the financial statements of the City of Costa Mesa, California (the City) including the Air Quality Improvement Special Revenue Fund (the AQMD), as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the City's basic financial statements, and have issued our report thereon dated December 26, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the City of Costa Mesa, California's internal control over financial reporting (internal control) as it relates to the AQMD as a basis for designing our audit procedures that are appropriate in the circumstances for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control related to AQMD. Accordingly, we do not express an opinion on the effectiveness of the City's internal control related to AQMD.

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

Internal Control Over Financial Reporting (Continued)

Budget Approval/Unrecorded Transactions

The City has an arrangement with an outside organization to provide funding to the City for promotional activities without a written agreement. The arrangement allows for the payment of certain City-related promotional expenditures directly by the outside organization which results in City-related expenditures being incurred without formal budget approval by the City Council. The absence of not having budget approval of these expenditures and related revenue allows for a lack of accountability and could result in misuse of the funds provided by the outside organization. In addition, since the payments for these City expenditures are being paid directly by the outside organization, the expenditures and related reimbursement are not being recorded on the City's general ledger. We recommend that the City enter into a written agreement with this organization in which the City would receive the funding directly and expenditures and revenues for this program would be approved by the City Council.

Purchasing Policies and Procedures

During our testing of cash disbursements, we noted that the City did not follow the established purchasing policies and procedures. The purchasing policy requires the following procedures:

1. Purchases over \$1,000 are required to be done through a purchase requisition process, which includes issuance of the Purchase Order upon the receipt of the purchase requisition approved by the appropriate personnel.
2. Informal bids are required for purchases up to \$50,000.
3. Formal bids are required for contracts greater than \$50,000 and must be approved by City Council.
4. Bidding process may be exempt in some cases including "emergency" or "sole source" suppliers.
5. Formal professional service agreements must be reviewed and signed.

For the sample of cash disbursements we tested, we noted incidents where purchase orders were not issued for some purchases over \$1,000. Additionally, some purchases did not go through the required procurement process, and there was no documentation that those purchases were exempt from the bidding process. We also tested a contract that was greater than \$50,000, which required formal bidding and the City Council approval. In this instance, there was no documentation that formal bidding was performed nor that the City Council had approved the contract.

Failure to follow the established purchasing policies and procedures could result in misappropriation of assets. We recommend that management review its process for following these procedures and include additional steps, if needed, to allow for the proper functioning of the purchasing policies and procedures.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the City's financial statements are free from material misstatements, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements including Assembly Bill 2766 (AB 2766) Chapter 1705 (Health and Safety Code Sections 44220 through 44247), noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted a certain other matter that we reported to management of the City of Costa Mesa in a separate letter dated December 26, 2013.

Purpose of this Report

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

White Nelson Diehl Evans LLP

Irvine, California
December 26, 2013