

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

We have audited the financial statements of the governmental activities, each major fund and the aggregate remaining fund information of the City of Costa Mesa, California (the City), as of and for the year ended June 30, 2012, which collectively comprise the City's basic financial statements and have issued our report thereon dated December 14, 2012. In planning and performing our audit of the financial statements of the City as of the year ended June 30, 2012, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified.

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. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

However, during our audit, we became aware of certain internal control deficiencies that are opportunities for strengthening internal controls and operating efficiency. These matters are set forth below, together with our recommendation for improvement.

Ethics Policy

The City has in place a number of practices to communicate its expectation of ethical behavior to all employees through verbal communications, trainings, and by setting proper tone at the top. However, the City does not have a formalized ethics policy. A structured ethics policy establishes organizational standards for ethics, morals, and an overall "regard for the rules" philosophical approach within an entity. Specifically, matters such as honesty, integrity, compliance with laws and regulations, adherence to corporate policy, and upholding the City's high values and reputation should be addressed. In addition, the City's practices do not include a clearly communicated process for employees to report suspected fraud or other unethical conduct. A strong ethics policy is the foundation upon which an organization builds its culture, which should then permeate all levels of personnel and guide all business dealings and transactions. This can be most effective in establishing a highly ethical and antifraud culture within any organization. We recommend the City adopt a formal ethics policy.

Compliance with Purchasing Policy

The City has a well-developed purchasing policy that outlines procedures with respect to purchasing and procurement. As part of our review of controls over cash disbursements, we found no evidence of inappropriate expenditures. We also found substantial compliance with City's purchasing policy, with the exception of the items below that represent minor deviations from the requirements of the purchasing policy:

- Section 2.3 of the policy requires that for purchases under \$1,000, a City Order Form must be completed and approved by appropriate persons. We noted one instance where a City Order Form was not completed for purchase of computer equipment. We recommend that City establish procedures that will ensure a City Order Form is completed for all purchases under \$1,000 as required by the City's purchasing policy.
- To facilitate efficient purchase of goods and services which are difficult to anticipate or required on a recurring basis, the City's purchasing policy allows for blanket purchase orders to be issued to local vendors within a pre-established time period which is usually for one to three years. We noted one instance where a purchase for office supplies was made under a blanket purchase order. However, the blanket purchase order expired in June 2011. The City has continued to make purchases under the same agreement terms. We recommend that the City ensure that blanket purchase orders are current.

Schedule of Expenditures of Federal Awards (SEFA)

For fiscal year 2012, the City had expenditures of over \$500,000 that were funded by federal grants and was subject to single audit. During our reconciliation of expenditures funded by federal grants reported in the SEFA (prepared by the City) to grant agreements and the general ledger, we noted expenditures for one grant included in the SEFA that were reported incorrectly as federal expenditures. The expenditures reported were the City's matching contribution for a grant received from City of Fullerton under the NSP program. We recommend that the City review its procedures for gathering information related to grants to ensure that amounts reported in the SEFA are accurate.

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

White Nelson Dick Evans LLP

Irvine, California
December 14, 2012