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City Council
City of Costa Mesa, California

In planning and performing our audit of the financial statements of the City of Costa Mesa (the "City") as of and for the year ended June 30, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion 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.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we considered to be material weaknesses.

The matters below do not represent significant deficiencies in internal control, but are offered for your consideration as an opportunity to further enhance the City's system of internal control:

(1) Ethics Policy

We evaluated the City's conformance to the best practices recommended by the Auditing Standards Board as a part of the new auditing standards that take effect for 2008 audits. We noted that the City already 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 our audit procedures revealed the City does not have a formalized ethics policy. A well 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 are addressed. We also noted that 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 business organization.

Recommendation

We recommend that the City establish and implement an ethics policy. We also suggest that the City implement an effective reporting mechanism for fraud and other unethical conduct. Internal reporting channels, such as hotlines for anonymous tips, or a clearly defined reporting protocol (what to report, who to report to, etc.), have been found to be effective. Generally, centralized reporting to a party (such as Human Resources, etc.) outside the involved department have been found to be most effective.

(2) Accounting for Cost Reimbursement Grants

The City receives grant funding from a number of sources. The activity for certain of these grants is properly recorded in individual special revenue funds. For cost reimbursement grants that are reflected in separate funds, the ending equity should be relatively small, as grant revenues should approximate grant expenditures annually. We noted that for the year ended June 30, 2009 the HOME Fund had a deficit in ending equity of \$385,049 and the Community Development Block Grant Fund had a deficit of \$90,745. The cause of these deficits could be the recording of expenditures that are not reimbursable or not claiming expenditures that are eligible for reimbursement. These funds should be reviewed to ensure that the activity for the cost reimbursement grants are being accounted for properly.

Recommendation

We recommend that the City review its current procedures in place to review and reconcile these grant funds. The City should also ascertain the reason for the accumulated fund deficits and implement procedures to investigate deficits in the future.

(3) Establish Policy to Address Stale Dated Checks

The June 2009 bank reconciliation included over 500 outstanding checks. Of those outstanding checks 68 had been outstanding over six months, and several checks had been outstanding since November 2007. The City currently does not have a written policy providing guidance on how to account for stale dated checks. The City should consider developing a written policy that would identify the procedures to be performed for checks outstanding over a certain period of time.

Recommendation

We recommend that the City create a policy for handling outstanding checks that are greater than a certain amount of time, perhaps six months. This policy should include guidance in researching the cause, sample entries to restore cash and situations when to issue another check to the payable party. This will allow for more complete and accurate accounting records.

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

Mayor Hoffmann McCann A.C.

Irvine, California
December 11, 2009