

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

In planning and performing our audit of the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Costa Mesa (City) as of and for the year ended June 30, 2018, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances 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. However, as discussed below, we identified a certain deficiency in internal control that we consider to be material weaknesses.

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 entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the following internal control issue to conform to that definition:

(1) Audit Adjustments and Prior Period Restatements

As a result of audit procedures, we proposed certain material audit adjustments as well as prior period adjustments. The accounting standards requires management to develop an effective internal control structure to identify material transactions and properly report them in the general ledger.

Recommendation

To minimize auditor detected adjustments and prior period adjustments, the City should improve procedures to, whenever possible, identify adjustments in the reporting period in which the related transactions occurred. It is recognized that this is not always possible and on occasion, the City accounting procedures will identify adjustments in subsequent periods. However, this should be mitigated when possible.

Management's Comments Regarding Corrective Actions Planned

The City concurs with the auditor's recommendation that improvements to our year-end close procedures are necessary. In preparation for the next year-end close, the City will develop procedures to ensure all material transactions are recorded in the proper reporting period.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following internal control issues to conform to that definition:

(2) Financial Health and Deficit Fund Equity

For the fiscal year ended June 30, 2018, the Governmental Activities of the City reported a deficit unrestricted net position of (\$224,657,548). Overall, the total net position of the Governmental Activities of the City is \$28,063,057. The unrestricted net position deficit is largely the result of the recent implementation of GASB Statement No. 68 that required the City to report net pension liabilities, and this year's implementation of GASB Statement No. 75 that required the City to report total OPEB liabilities. As of June 30, 2018, the City's net pension liability and total OPEB liability were \$300,897,566 and \$53,432,728, respectively, of which the entire amounts are payable from Governmental Activities.

We also noted that the City's Self Insurance Worker's Compensation and General Liability Internal Service Fund had a deficit equity balance at the end of year of (\$3,489,039). We noted that the City made efforts during the fiscal year to decrease the fund's deficit; however, a deficit balance still exists at year end.

Recommendation

We recommend the City continue to evaluate solutions for improving the overall Governmental Activities Unrestricted Net Position and for funding the Self Insurance Worker's Compensation and General Liability Internal Service Fund.

Management's Comments Regarding Corrective Actions Planned

The City concurs with the auditors' recommendation and is actively working on funding plans to address the City's pension, OPEB and self-insurance liability issues.

(3) Financial Accounting System

The City's financial accounting system has not been substantially upgraded in a number of years and the current version of the system is no longer supported by the vendor. The current system properly records accounting information; however, it can be time intensive and costly to retrieve certain information from the system in a format that is useful for management.

Additionally, during our audit, we performed a review of the City's information systems (IT) internal controls. We noted the following areas where controls could be strengthened:

- a) The City does not have documented policies and procedures over IT general controls, including access management, change management, and data backup.
- b) The City does not provide initial (upon hire) security awareness training and training annually thereafter.
- c) The City does not perform a periodic review of user accounts to sensitive systems, including access to the network (and VPN) and financial software.
- d) The City has not performed a recent system recovery to ensure the backup process is adequate and working properly.

Recommendations

We recommend the City evaluate the current accounting systems to determine if it is sufficient to provide management with timely and useful information.

The City should also consider implementing the following controls over the IT area:

- a) Document policies and procedures over IT systems, including an access management policy, change management procedures, and data backup procedures. Implement a process for tracking changes to applications, to include tracking of the request, testing, and approvals.
- b) Implement a security awareness training program for employee to complete upon hire and annually thereafter. The City should use the phishing program as a guide for personnel that require additional awareness training.
- c) Perform a periodic review of user access to sensitive systems, including active directory, financial system, and remote access. The review should be completed at a period (e.g., quarterly, semi-annually, annually) based on the risk of the system/data risk.
- d) Periodically perform a system recovery to ensure backups are adequate to restore the system.

Management's Comments Regarding Corrective Actions Planned

During 2018, the City engaged a consultant to conduct an IT Strategic Plan to identify software, staffing and procedural improvements needed to address the City's technology concerns. The consultant's fieldwork has been completed; however, the consultant has not completed his report. The report is expected to be finalized in the first quarter of 2019. We expect the recommendations will be in line with those noted above, many of which the IT Department has already begun addressing.

In addition, the City has begun the process of identifying a new accounting system and has already dedicated funding in the IT Replacement Internal Service Fund. Over the next year, the Finance and IT Departments will work closely to develop an implementation plan to bring our accounting system up to date.

(4) Internal Controls over Cash Disbursements

During our review of purchasing controls, we noted the individuals who process disbursements in the accounting system also have the ability to add/modify vendor information. Additionally, the system allows budget overrides and once a budget override has been done for an expense account, the system no longer alerts the user that the expense account is over budget. The City conducts reviews of the final warrant register to identify new vendors and budget overrides; however, ideally the City would utilize system controls to support proper segregation of duties and budget controls.

Recommendation

We recommend the City evaluate the procedures in place to add/modify vendors and create budget overrides and consider reassigning duties or implementing additional systems or process controls.

Management's Comments Regarding Corrective Actions Planned

The City concurs with this finding and has already taken steps to limit staff access to add/modify vendors.

The deficiency to create budget overrides was previously identified by management and this functionality was turned off prior to the start of the audit; however, the lack of internal controls was present during the period being audited. We believe we have adequately addressed this concern.

During our audit, we also became aware of the following internal control issues that is not a significant deficiency or material weakness but offers an opportunity for strengthening internal controls and operating efficiency:

(5) Timely Invoicing of Grant Expenditures

During our audit, we noted that there are no established procedures for the invoicing of grant expenditures and that the current invoicing practice has contributed to the City's delay in recording revenue in a timely and accurate manner. For a certain grant, we noted that reimbursable expenditures incurred in 2017 had not been invoiced until September 2018.

Recommendation

Management should investigate the reasons behind delays in grant billing and consider implementing a formal policy, so program and accounting personnel have a clear understanding of expectations and roles related to the approval of invoices sent to the City's grantors. As a best practice, invoices should be sent to grantors at least on a quarterly basis, which should increase cash collections and better maintain the accuracy of the grants receivable balance.

Management's Comments Regarding Corrective Actions Planned

The City concurs with the auditor's finding and will work on improving communication between the departments to ensure reimbursement requests are submitted timely.

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

A handwritten signature in blue ink that reads "Davis" followed by a stylized flourish.

Irvine, California
December 21, 2018