

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, 2019, 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 certain deficiencies in internal control that we consider to be significant deficiencies.

*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 did not identify any material weaknesses in internal control.

*A significant deficiency* is defined to be 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 issues to conform to that definition:

(1) Financial Health and Deficit Fund Equity

We noted certain deficit balances in the financial statements that warrant management's attention. For the fiscal year ended June 30, 2019, the City reported a positive net position of \$28,658,066. However, after removing amounts that are restricted for specific purposes or invested in capital assets, the City reported a deficit unrestricted net position of (\$241,478,263). The unrestricted net position deficit is largely the result of the recent accounting standards that required the City to report net pension liabilities and total Other Post Employment Benefit ("OPEB") liabilities. As of June 30, 2019, the City's net pension liability and total OPEB liability were \$295,591,759 and \$53,202,676, respectively.

We also noted that two of the City's Internal Service Funds did not have sufficient revenues to cover expenses during the year. The Self Insurance Worker's Compensation and General Liability Internal Service Fund expenses exceeded revenues by \$1,181,914 during the year which increased the fund deficit to (\$4,670,953) at June 30, 2019. The Equipment Replacement Fund expenses exceeded revenue by \$796,404 during the year which resulted in deficit cash and subsequent borrowing from other City funds.

Recommendation

We recommend the City continue to evaluate solutions for improving the overall Unrestricted Net Position deficit caused by the pension and OPEB liabilities. Additionally, the City should evaluate the Internal Service Fund charges for services to ensure the charges to other City

funds are sufficient to cover expenses in those shared services funds.

#### Management's Comments Regarding Corrective Actions Planned

The City concurs with the auditor's recommendation and is actively working on a funding plan to address the city-wide long-term obligations such as pensions and OPEB. In addition, the insufficient revenues in the internal service funds were identified by the Finance Department in early 2019 and the department has been working on a plan to fund those costs. The issues in these funds developed over many years and will take some time to resolve, however, we anticipate making significant improvements over the next fiscal year.

#### (2) 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 prior year audit, we performed a review of the City's information systems (IT) internal controls. Of the four specific recommendations we communicated in the prior year, two were fully addressed by the City and one was partially addressed. The City should continue making improvements in IT controls in the following areas:

- 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 perform periodic reviews of user accounts; however, we noted that a recent review had not been performed for financial system access, which would include remote access.

#### Recommendations

We recommend the City evaluate options for upgrading or replacing the current accounting system to a system that is supported by the vendor and able to provide information to management in a timely and simple manner.

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) Continue performing periodic reviews of user access to sensitive systems, including active directory, financial system, and remote access. The review should include financial system access, including remote access.

#### Management's Comments Regarding Corrective Actions Planned

The City concurs with the auditor's recommendations. During fiscal year 2018-19, the City Council dedicated funding in the IT Replacement Internal Service Fund for a new Enterprise Resource Planning (ERP) system. The new ERP system, when implemented, will replace the outdated financial software and bring additional internal controls and operational efficiency to financial reporting. The City has already contracted with a consultant to start the development of a Request for Proposal for an ERP system, however due to other system implementations that are ongoing, the ERP system is not scheduled to be replaced until 2022 at the earliest.

The IT Department is also in the process of writing the policies and procedures for IT systems, including an access management policy and change management procedures. Data backup

policies will be posted on the IT Policy section of the City's intranet beginning in December 2019. The department is creating procedures which will document the systemic reviews of user access to sensitive systems, including the active employee directory, financial systems, and remote access.

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 Lan up". The signature is written in a cursive, flowing style.

Irvine, California  
December 13, 2019