

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, 2020, 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 issue 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, 2020, the City reported a positive net position of \$21,765,850. However, after removing amounts that are restricted for specific purposes or invested in capital assets, the City reported a deficit unrestricted net position of (\$251,417,100). 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, 2020, the City's net pension liability and total OPEB liability were \$304,665,311 and \$58,917,480, respectively.

Recommendation

We recommend the City continue to evaluate solutions for improving the overall Unrestricted Net Position deficit caused by the pension and OPEB liabilities.

Management's Comments Regarding Corrective Actions Planned

The City concurs with the auditor's recommendation and continues to work on a funding plan to address the city-wide long-term obligations such as pensions and OPEB. The funding plan includes setting aside funds for a Section 115 pension trust; prepaying pension obligations annually, which saves the City approximately \$760,000; and depositing an additional \$500,000 annually towards the unfunded pension liability in the Fire Side Fund.

The City also strives to manage its pension liability through workforce recruitment. The City implemented tier 2 pension formulas for classic employees in addition to the Public Employees' Pension Reform Act (PEPRA) formulas established statewide. These new formulas aim to reduce long-term pension liability as the City recruits new talents.

Fiscal year 2019-20 was a year filled with challenges, primarily brought on by the unprecedented COVID-19 pandemic. At the onset of the pandemic, the City Council and management quickly implemented a comprehensive cost containment plan to reduce significant operating expenses. The strong budgetary flexibility and leadership enabled the City to end fiscal year 2019-20 in balance without using reserve funds.

Furthermore, Standard and Poor's (S&P) reaffirmed the City's lease revenue bonds AA+ rating in December 2020 based on a very strong and diverse economy, very strong management and financial practices, and strong liquidity and debt position. The City remains committed to address its long-term pension and OPEB obligations through its proven ability to manage the City's finance.

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 Lane" followed by a stylized flourish.

Irvine, California
February 17, 2021