TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Report</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards</td>
<td>1 - 2</td>
</tr>
<tr>
<td>Independent Auditor's Report on Report on Compliance Requirements that Could Have a Direct and Material Effect on Each Major Program and on Internal Control over Compliance in Accordance with OMB A-133</td>
<td>3 - 4</td>
</tr>
<tr>
<td>Schedule of Expenditures of Federal Awards</td>
<td>5</td>
</tr>
<tr>
<td>Notes to the Schedule of Expenditures of Federal Awards</td>
<td>6</td>
</tr>
<tr>
<td>Schedule of Findings and Questioned Costs</td>
<td>7</td>
</tr>
<tr>
<td>Schedule of Current Year Findings</td>
<td>8</td>
</tr>
<tr>
<td>Schedule of Prior Year Findings</td>
<td>9 - 12</td>
</tr>
</tbody>
</table>
REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the City Council of
the City of Novato
Novato, California

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Novato (the “City”), as of and for the year ended June 30, 2012, which collectively comprise the City of Novato’s basic financial statements and have issued our report thereon dated December 20, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the City of Novato is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, 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 over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the City’s internal control over financial reporting.

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 combination of deficiencies, in internal control such that there is reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control over financial reporting, described in the accompanying schedule of findings and questioned costs that we consider to be significant deficiencies in internal control over financial reporting (2012-01). 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.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the City’s financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

We noted certain matters that we reported to management of City, in a separate letter dated December 20, 2012.

The City of Novato’s responses to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. We did not audit the City of Novato’s responses, and accordingly, we express no opinion on it.
This report is intended solely for the information and use of management, the City Council, others within the entity, and pass-through entities and is not to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Sacramento, California
December 20, 2012
INDEPENDENT AUDITOR’S REPORT ON COMPLIANCE REQUIREMENTS
THAT COULD HAVE A DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM
AND ON INTERNAL CONTROL OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133

To the City Council of
the City of Novato
Novato, California

Compliance

We have audited the City of Novato’s (the City) compliance with the types of compliance requirements described in the OMB Circular A-133 Compliance Supplement that could have a direct and material effect on each of the City of Novato’s major federal programs for the year ended June 30, 2012. The City of Novato’s major federal programs are identified in the summary of auditor’s results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the City of Novato’s management. Our responsibility is to express an opinion on the City of Novato’s compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the City of Novato’s compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the City of Novato’s compliance with those requirements.

In our opinion, the City of Novato complied, in all material respects, with the requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2012.

Internal Control Over Compliance

Management of the City of Novato, is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the City of Novato’s internal control over compliance with the requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the City of Novato’s internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.
Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

**Schedule of Expenditures of Federal Awards**

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Novato, as of and for the year ended June 30, 2012, and have issued our report thereon dated December 20, 2012, which contained unqualified opinions on those financial statements. Our audit was performed for the purpose of forming opinions on the financial statements as a whole. The schedule of expenditures of federal awards is presented for the purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

This report is intended solely for the information and use of management, City Council, others within the entity, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Sacramento, California

December 20, 2012
<table>
<thead>
<tr>
<th>Federal Grantor/Pass-Through Grantor Program</th>
<th>Pass-Through Entity Identifying Number/Grant Number</th>
<th>Federal Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>U.S. Department of Justice</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct Programs:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Edward Byrne Memorial Justice Assistance Grant Program</td>
<td>16.738 ZA09010210</td>
<td>$108,991</td>
</tr>
<tr>
<td>Edward Byrne Memorial Justice Assistance Grant Program</td>
<td>16.738 2010-DJ-BX-1293</td>
<td>$2,000</td>
</tr>
<tr>
<td>Edward Byrne Memorial Justice Assistance Grant Program</td>
<td>16.738 2009-SB-B9-0966</td>
<td>$28,497</td>
</tr>
<tr>
<td>Total Justice Assistance Grants</td>
<td></td>
<td>$139,488</td>
</tr>
<tr>
<td><strong>Total U.S. Department of Justice</strong></td>
<td></td>
<td>$248,071</td>
</tr>
<tr>
<td><strong>U.S. Department of Transportation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pass-Through State of California Office of Traffic Safety:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>State and Community Highway Safety</td>
<td>20.600 20115</td>
<td>$90,562</td>
</tr>
<tr>
<td>State and Community Highway Safety</td>
<td>20.600 PS1103</td>
<td>$29,167</td>
</tr>
<tr>
<td>Total Highway Safety</td>
<td></td>
<td>$119,729</td>
</tr>
<tr>
<td>Pass-Through State of California Department of Transportation:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Highway Planning and Construction</td>
<td>20.205 NMTPL-5361(020)</td>
<td>$300,000</td>
</tr>
<tr>
<td>Highway Planning and Construction</td>
<td>20.205 BHLS-5361(023)</td>
<td>$20,268</td>
</tr>
<tr>
<td>Highway Planning and Construction</td>
<td>20.205 NMTPL-5361(020)</td>
<td>$1,396,320</td>
</tr>
<tr>
<td>Total Highway Planning and Construction</td>
<td></td>
<td>$1,716,588</td>
</tr>
<tr>
<td><strong>Total U.S. Department of Transportation</strong></td>
<td></td>
<td>$1,836,317</td>
</tr>
<tr>
<td><strong>U.S. Department of Energy</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct Programs:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Energy Efficiency and Conservation Block Grant Program (EECBG)</td>
<td>81128 DE-SC0001297</td>
<td>$171,732</td>
</tr>
<tr>
<td><strong>Total U.S. Department of Energy</strong></td>
<td></td>
<td>$171,732</td>
</tr>
<tr>
<td><strong>Total Expenditures of Federal Awards</strong></td>
<td></td>
<td>$2,256,120</td>
</tr>
</tbody>
</table>
NOTE 1: REPORTING ENTITY

The accompanying Schedule of Expenditures of Federal Awards presents the activity of all federal financial assistance programs of the City of Novato. The City of Novato reporting entity is defined in Note 1 of the City's Comprehensive Annual Financial Report. All federal awards received directly from federal agencies as well as federal awards passed through other government agencies are included on the schedule. When federal awards were received from a pass-through entity, the Schedule of Expenditures of Federal Awards shows, if available, the identifying number assigned by the pass-through entity.

NOTE 2: BASIS OF ACCOUNTING

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the City and is presented on accounting principles generally accepted in the United States of America. The information in this schedule is presented on the accrual basis of accounting and in accordance with requirements of OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations.

NOTE 3: RELATIONSHIP TO FINANCIAL STATEMENTS

The amounts reported in the accompanying Schedule of Expenditures of Federal Awards agree, in all material respects, to amounts reported within the City's basic financial statements. Federal award revenues are reported principally in the City's financial statements as intergovernmental revenues in the governmental funds.

NOTE 4: CLAIMS

The City of Novato has received federal grants for specific purposes that are subject to review and audit by the Federal Government pass-through entity. Although such audits could result in expenditure disallowance under grant terms, any required reimbursements are not expected to be material which have not already been recorded.
SECTION I - SUMMARY OF AUDITOR'S RESULTS

Financial Statements

Type of auditor's report issued: Unqualified

Internal control over financial reporting:

  Material weakness(es) identified? No
  Significant deficiency(ies) identified Yes
  Noncompliance material to financial statements noted? No

Federal Awards

Internal control over major programs:

  Material weakness(es) identified? No
  Significant deficiency(ies) identified? None reported

Type of auditor's report issued on compliance for major programs: Unqualified

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133? No

Identification of Major Programs:
  U.S. Department of Transportation, Highway Planning and Construction, CFDA 20.205

  Dollar threshold used to distinguish between type A and type B programs: $300,000

  Auditee qualified as low-risk auditee? No

SECTION II - FINANCIAL STATEMENT FINDINGS

Findings relating to the financial statements which are required to be reported in accordance with Generally Accepted Government Auditing Standards Yes

SECTION III - FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

Findings and questioned costs for Federal Awards, which includes audit findings and defined in section 510(a) No
Finding 2012-01: Fund 701 Deposits in Trust and Fund 325 Restricted Revenues (Significant Deficiency)

Criteria

Certain deficiencies in internal control system over financial reporting could adversely affect an entity’s ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Condition

The City’s fund 325 is used to account for restricted revenues and fund 701 is used to account for deposits. Both of these funds included deposits that are over 10 years old whose status was not able to be determined.

Cause

Management noted that when projects were completed in prior years, the planning and engineering department personnel did not initiate refund procedures and the deposits stayed with the City.

Recommendation

We recommend that the City perform a thorough review and reconciliation of these deposit accounts to determine if monies are owed to developers, or if these deposits were provided to the City as a non-refundable contribution in which case the City should have recorded the amounts into revenue.

Management’s Response

In regards to fund 325, the City engineering department has reviewed the balances and performed procedures to identify the status of the projects. The Finance Department and Engineering Department has consulted with legal counsel as to the treatment of these balances and was advised that due to the lack of information on the old projects and the time that has lapsed, the restrictions have expired and the funds are available to be transferred to other CIP projects. In regards to fund 701, the City began reviewing the balances in the deposit accounts and performed procedures to identify the original depositor to return the funds. However, during year-end, the City did not have sufficient staffing levels to continue to review and research the deposit balances to return the funds. The City has decided to post notices in newspapers to invite claims to the cash balances that management is unable to identify the name of the original depositor and the process is on-going.
Finding 2011-1: Marin Valley Mobile Country Club (Material Weakness)

Condition

1. In the prior year financial statements, the City had maintained an expendable trust fund for the Novato Financing Authority. In accordance with GASB 34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments, which was effective for the City in fiscal year 2004, expendable trust funds were eliminated and no longer exist. The fund was classified incorrectly in the prior year financial report.

2. Currently, a third party property management company maintains the operations of the mobile home park. Monthly reports are provided to the City for review. However, the property management company maintains their records on a cash basis and several adjustments are needed for accrual basis.

3. As part of the above process, we discovered that there were cash deposits that had already been deposited into the bank, however, were not recorded in the general ledger as of year-end.

Recommendation

1. Based on the sources and uses of the fund, we recommend that the City include this fund as a proprietary fund as the fund accounts for activity related to the operation and maintenance of a mobile home park.

2. In order to covert the financial information into accrual, we recommend the City include the activity of the mobile home park in their general ledger to ensure that financial records are in accordance with generally accepted accounting principles. A month-end or year-end reconciliation and review should be performed and the fund should be included in the City's overall financial analysis.

3. We recommend that the City review the bank reconciliations performed by the property management company and ensure they are reconciled as of the fiscal year-end date.

Status: Implemented

Finding 2011-2: Fund 701 Deposits in Trust (Material Weakness)

Condition

In the prior year financial statements, the City had maintained a non-expendable trust fund for the purposes of holding developer deposits. However, this type of fund no longer exists. Further, per review of the fund's activity, it was noted that 60% of the $585,000 in deposits included in the liability account are over 10 years old.

Recommendation

Based on the sources and uses of the fund, we recommend that the City include this as a sub-fund of the General Fund. We also recommend that management research the projects to determine if any deposit amounts need to be refunded.

Status: Implemented General Fund sub-fund; partially implemented review of deposits - see current year findings.
Finding 2011-3: Fund 325 Deposits in Trust (Material Weakness)

Condition

The City’s fund 325 is used to account for restricted revenues. Included in this fund is $944,000 in deposits. During our audit of this account, we discovered that 66% of the total deposits are over 10 years old, and that the Engineering Department was unable to identify the current status of approximately 74% of the deposits.

Recommendation

We recommend that the City perform a thorough review and reconciliation of these deposit accounts to determine if monies are owed to developers, or if these deposits were provided to the City as a non-refundable contribution in which case the City should have recorded the amount into revenue.

Status: Partially implemented - see current year findings.

Finding 2011-4: Interfund Interest (Significant Deficiency)

Condition

During the current year, a resolution was passed for the Redevelopment Agency to pay-off certain promissory notes it had with other funds. Included in this pay-off was over $6,000,000 in interest to the City's General Fund. Upon review of the general ledger, we noted that the City recorded this interest revenue as a miscellaneous holding liability account. Recording this amount as a liability misstates the financial statements.

Recommendation

We proposed an entry to reclassify the amount as interest revenue. Further, if it is management's intent to set-aside funds for a project, we recommend they do so by committing or assigning fund balance in accordance with GASB 54, Fund Balance Reporting and Fund Type Definitions.

Status: Implemented

Finding 2011-5: Miscellaneous Holding Accounts (Significant Deficiency)

Condition

We discovered that the City had approximately $200,000 in liability ("holding") accounts that did not represent true liabilities or unearned revenue at year-end. We were informed that these funds were recorded into a liability account as a set-aside. The original sources of these funds were unrestricted revenues. Generally accepted accounting principles (GAAP) direct that governmental funds recognize revenues "in the accounting period in which they become susceptible to accrual – that is when they become both measurable and available to finance expenditures of the fiscal period."

Recommendation

If it is the City's intent to "set-aside" funds, we recommend they do so by committing or assigning a portion of fund balance, in accordance with GASB 54, Fund Balance Reporting and Governmental Fund Type Definitions.

Status: Implemented
Finding 2011-6: Year-End Closing Procedures (Significant Deficiency)

Condition

During the audit, there were over 25 journal entries proposed and recorded. Also, the auditors had to provide assistance beyond the scope of their services to assist in reconciling accounts and preparing journal entries.

In addition, it was noted that there were several full-accrual adjustments needed in order to bring the governmental fund financial statements from modified accrual to full accrual.

Recommendation

We believe that the year-end closing could proceed more quickly and smoothly by developing a logical order for closing procedures and assigning responsibility for completing the procedures to specific City personnel. The closing procedures should be documented in a checklist that indicates who will perform each procedure and when completion of each procedure is due and is accomplished. The timing of specific procedures could be coordinated with the timing of management's or the auditor's need for the information.

The City already had a long-term debt and a general capital asset fund set-up to record such full-accrual transactions; however we recommend that all full-accrual adjustments be recorded in a “GASB 34-like” fund. Items that were not recorded in the long-term debt group or general capital assets include: prepaid PERS contribution, interest payable, bond issuance costs/discounts/premiums and related amortization/accretion, OPEB liability, and the Redevelopment Agency’s prepaid lease. Having this activity recorded in a fund of the general ledger will serve as a tracking device for the City and also provide the auditors with balances to audit.

Status: Implemented

Finding 2011-07: Redevelopment Agency Housing Fund Expenditures (Compliance)

Condition

The Redevelopment Agency of the City does not have a written determination showing that planning and administrative expenditures were necessary for the production, improvement, or preservation of low and moderate income housing.

Recommendation

We recommend the Agency prepare a written determination showing that planning and administrative expenditures were necessary for the production, improvement, or preservation of low and moderate income housing to be included in the annual budget for Board approval.

Status: Not applicable - redevelopment agencies were dissolved during the fiscal year.
Finding 2011-8: Redevelopment Agency - Implementation Plan (Compliance)

Condition


Recommendation

We recommend the Agency complete their five-year implementation plan as soon as possible and provide it to their governing board for adoption.

Status: Not applicable - redevelopment agencies were dissolved during the fiscal year.