MAYER HOFFMAN MCCANN P.C.
(IRVINE OFFICE)

Review Report

QUALITY CONTROL REVIEW

For the Firm's Audits of
City of Bell and **Bell Community Redevelopment Agency**
for the Fiscal Year Ended June 30, 2009

JOHN CHIANG
California State Controller

December 2010

JOHN CHIANG
California State Controller

December 21, 2010

William Hancock, Shareholder
Mayer Hoffman McCann P.C.
11440 Tomahawk Creek Parkway
Leawood, KS 66211

Michael A. Harrison, Shareholder
Mayer Hoffman McCann P.C.
2301 Dupont Drive, Suite 200
Irvine, CA 92618

Dear Mr. Hancock and Mr. Harrison:

The State Controller's Office (SCO) completed a quality control review of Mayer Hoffman McCann P.C. (Irvine office). We reviewed the audit working papers for the firm's audit of City of Bell and the compliance audit of the Bell Community Redevelopment Agency for the fiscal year ended June 30, 2009.

A draft report was issued on October 25, 2010. The firm's responses to the draft report are included in our final report.

Please contact Casandra Moore-Hudnall, Chief, Financial Audits Bureau, at (916) 322-4846 for Single Audit questions and Steve Mar, Chief, Local Government Audits at (916) 324-7226 for Redevelopment Agency Audits.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

JVB/sk:wm

Attachment

cc: Pedro Carrillo
Interim Chief Administrative Officer
City of Bell
Stephen J. Tully, Attorney
Garrett & Tully, P.C.
Paul Riches, Deputy Director
Enforcement and Compliance Board of Accountancy

Contents

Review Report

Summary

The State Controller's Office (SCO) completed a quality control review of Mayer Hoffman McCann P.C.'s (Irvine office) working papers for the audit of the City of Bell and the compliance audit of the Bell Community Redevelopment Agency for the fiscal year (FY) ended June 30, 2009 (FY 2008-09).

The firm's audits were performed in accordance with some of the standards and requirements set forth in *Government Auditing Standards*, issued by the Comptroller General of the United States, often referred to as generally accepted government auditing standards (GAGAS); U.S. generally accepted auditing standards (GAAS); Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*; the California Business and Professions Code; and the Guidelines for Compliance Audits of California Redevelopment Agencies (RDA Audit Guide). However, the firm did not comply, to varying degrees, with the majority of fieldwork auditing standards with regard to audit documentation, audit evidence, risk of fraud, litigation, claims and assessments, subsequent events, going concern, and OMB Circular A-133 requirements for testing federal program internal control and compliance. In addition, the firm did not comply with the RDA Audit Guide in testing for allowable expenditures.

Finally, the firm did not comply with section 5097 of the California Business and Professions Code.

Background

A single audit of any governmental unit must be performed in accordance with the standards referred to in this report. According to OMB Circular A-133, the auditor's work is subject to a quality control review at the discretion of an agency granted cognizant or oversight status by the federal funding agency.

As coordinating agency for single audits of local governments, the SCO may perform quality control reviews of audit working papers to determine whether audits are performed in conformity 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 of America.

Mayer Hoffman McCann P.C.—based in Leawood, Kansas—bought Conrad and Associates LLP in 2006 and formed a new division that specializes in audits of municipalities and government agencies.

The firm—located in Irvine, California—has been the independent auditor for the City of Bell since 2006. Conrad and Associates LLP was the independent auditor for the City of Bell from 1994 to 2006.

Objectives, Scope, and Methodology

The general objectives of our quality control review were to determine whether the firm's audits were conducted in compliance with:

- GAGAS
- GAAS
- OMB Circular A-133
- California Business and Professions Code
- Guidelines for Compliance Audits of Redevelopment Agencies

We used the following references as criteria:

- Codification of Statements on Auditing Standards–Numbers 1 to 116, as of January 1, 2009, published by the American Institute of Certified Public Accountants (AICPA)
- *Government Auditing Standards* (Yellow Book), issued by the Comptroller General of the United States, July 2007 Revision
- Office of the Management and Budget (OMB) Circular A-133 and its Compliance Supplement, March 2009
- Accounting and Audit Guide, State and Local Governments (AAG-SLV), March 1, 2009, published by the AICPA
- Audit Guide, Government Auditing Standards and Circular A-133 Audits, August 1, 2008, published by the AICPA
- Original Pronouncements, Government Accounting and Financial Reporting Standards, Volume II, as of June 30, 2009
- Codification of Governmental Accounting and Financial Reporting Standards, as of June 30, 2009
- Government Accounting Standards Board (GASB) Comprehensive Implementation Guide, for guides issued through June 30, 2009
- Accounting Standards, published by the Financial Accounting Standards Board (FASB), as of June 30, 2009
- *Guidelines for Compliance Audits of Redevelopment Agencies*, November 1998

The firm provided copies of the working papers for our review. We compared the audit work performed by the firm, as documented in the working papers, with the standards stated in the general objectives.

Conclusion

Mayer Hoffman McCann P.C.'s audits of the City of Bell and Bell Community Redevelopment Agency were performed in accordance with some of the standards and requirements set forth in GAGAS, GAAS, OMB Circular A-133, the California Business and Professions Code, and the RDA Audit Guide. However, the firm did not comply, to varying degrees, with the majority of fieldwork auditing standards with regard to audit documentation, audit evidence, risk of fraud, litigation, claims and assessments, subsequent events, going concern, and OMB Circular A-133 requirements for testing federal program internal control and

compliance. In addition, the firm did not comply with the RDA Audit Guide in testing for allowable expenditures. Finally, the firm did not comply with section 5097 of the California Business and Professions Code. The basis for our conclusions are discussed in the Findings and Recommendations section of this report.

This report is applicable solely to the audit working papers of the City of Bell and the compliance audit of the Bell Community Redevelopment Agency for FY 2008-09 and is not intended to pertain to any other work of Mayer Hoffman McCann P.C.

Views of Responsible Officials

We issued a draft report on October 25, 2010. The firm responded by letters dated November 11, 2010 and December 8, 2010, disagreeing with the review results. On December 3, 2010 we held an exit conference with firm shareholders, William Hancock, Ken Al-Iman, and Richard Howard, Jr., as well as with Stephen Tully, the firm's legal counsel.

Subsequent to the exit conference, the firm requested another meeting. On December 20, 2010, we met with firm shareholders, William Hancock, Ken Al-Iman, Michael Harrison, and Senior Manager, Dean Votava. The firm stated that city officials provided false audit evidence and colluded to conceal information from the firm's audit team. The firm also continued to disagree with the results of our review.

At the December 20, 2010 meeting, we provided the firm the opportunity to send an additional response delineating any other concerns regarding our review, and informed them that we would need to receive any additional materials no later than noon on December 21, 2010. The firm did not provide an additional response by the deadline.

The final report includes our revisions made to the findings as a result of the firm's responses and the exit conference:

- November 11, 2010 response (Appendix 1)
- December 8, 2010 letter (Appendix 2)
- December 18, 2010 letters (Appendix 3)

The attachments provided by the firm are listed below:

Attachments 1 through 9 provided to the SCO with the firm's response in Appendix 1 are not included in the final report because they are the firm's working papers, thus may be considered confidential information.

1. City of Bell Fraud Prevention Policy
2. Entity and Activities Controls – City of Bell
3. Sopp Chevrolet Transaction Loan
4. Subsequent Events E-mails
5. Subsequent Event E-mail $35,000,000 Series 2007 Issue

6. Subsequent Event E-mail – Best, Best & Krieger
7. Fraud Risk Communication with Bell City Council – April 8, 2009
8. Communication with Bell City Council Pertaining to Fraud Risks and Other Matters on December 18, 2009
9. City of Bell Management Representation Letter
10. Controller John Chiang's Letter of Understanding dated August 3, 2010 regarding City of Bell Quality Control Review (included in Appendix 1)

Restricted Use

This report is intended solely for the information and use of the specified parties; it is not intended to be and should not be used for any other purpose. This restriction is not meant to limit distribution of the report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

December 21, 2010

Findings and Recommendations

General

The Single Audit Act requires that audits be performed in accordance with U.S. generally accepted auditing standards (GAAS). These standards govern the quality of the audits performed by independent auditors and have been approved and adopted by the American Institute of Certified Public Accountants (AICPA). GAAS is divided into three areas: (1) general standards; (2) fieldwork standards; and (3) reporting standards. The three areas are divided into ten specific standards. Auditors of governmental entities must also perform audits in accordance with generally accepted government auditing standards (GAGAS), which expands GAAS in several areas.

Health and Safety Code section 33080.1(a)(1) requires the independent financial audit of a redevelopment agency be conducted by a certified public accountant or public accountant, licensed by the State of California, in accordance with *Government Auditing Standards* adopted by the Comptroller General of the United States. In addition, the audit report must meet, at a minimum, the audit guidelines prescribed by the State Controller's Office (SCO) pursuant to section 33080.3, and include a report of the agency's compliance with laws, regulations, and administrative requirements governing activities of the agency.

In the course of this quality control review, we found that Mayer Hoffman McCann P.C. (MHM) did not comply, to varying degrees, with the majority of the fieldwork auditing standards and OMB Circular A-133 requirements in its audit of the City of Bell. In addition, the firm did not comply with the Guidelines for Compliance Audits of California Redevelopment Agencies (RDA Audit Guide) in testing expenditures of the Bell Community Redevelopment Agency. Finally, the firm did not comply with section 5097 of the California Business and Professions Code.

SCO Comments to MHM's November 11, 2010 Response

DISAGREEMENT WITH SCO DRAFT CONCLUSION

We appreciate the firm's acknowledgement that there are areas for improvement based on our quality control review and that the firm plans to use the results to update policies and develop additional guidance. In addition to determining whether audits are conducted in compliance with standards and other requirements, our objective is to improve the quality of single audits of local governments and audits of redevelopment agencies.

However, based on the number and significance of the findings, our overall conclusions remain unchanged.

REQUEST FOR EXIT CONFERENCE

We agree that it is important for the public good that both the SCO and the firm have accurate and objective reporting. However, the SCO audit report that the firm referred to was not a part of this quality control review. The scope of this review was limited to the audit working papers for the fiscal year ended June 30, 2009, as clearly noted throughout the report.

We did not believe that an exit conference was necessary because we provided the firm with a copy of the draft report for its review and provided the firm an opportunity to provide additional information or documentation for our consideration. The firm reviewed the draft report and provided additional information and documentation that we considered in finalizing the report. The firm did not request an exit conference prior to the issuance of the draft report. An exit conference would not have served any further purpose when the draft report was issued.

The quality control review process normally begins with an entrance conference at the audit firm's location, followed by fieldwork; and at the end of fieldwork, an exit conference is held to present the preliminary results of the review. However, as noted below, the firm, through its attorney, proposed an alternative review process. The firm chose not to meet with us so an entrance conference was not held, and fieldwork was conducted at the SCO offices. As a result, an exit conference was not conducted upon the completion of fieldwork, but was held on December 3, 2010, after the firm responded to the draft report.

BACKGROUND OF REVIEW

We originally contacted the firm by phone on July 28, 2010 to arrange an entrance conference for the quality control review of the firm. The firm did not respond to several voice-mail messages left with two different firm members, or to an e-mail message sent on July 30, 2010. On August 2, 2010, we received a phone call from the firm's attorney inquiring about the SCO's authority to perform a quality control review of the firm. After discussion with us, the attorney agreed to arrange an entrance conference with the firm on August 5, 2010. On August 3, 2010, the attorney phoned us and proposed that the firm deliver a laptop containing the electronic working papers for the audit and other requested documentation to our Culver City Office, in lieu of an entrance conference and conducting the review at the firm's office. We accommodated their request even though this alternative process was outside of our normal protocol. As a result, the scheduled entrance conference was not held and we had no access to the firm's audit staff during fieldwork.

A laptop containing the working papers and other documentation was delivered to our Culver City Office on August 5, 2010, and additional working papers were delivered on August 13, 2010. On September 16, 2010, we requested additional information from the firm through its

attorney. That information was provided to us on September 27, 2010 through the attorney. Our draft report was issued on October 25, 2010, less than one month later.

Our quality control review process involves an extensive review of the firm's audit working papers to determine compliance with applicable auditing standards, laws and regulations. The documentation of this process is subject to several levels of review to ensure that the work performed is complete and that any findings are accurate and supported. A draft report is then prepared which also is subject to several levels of review. As a result, it is not uncommon for this process to take several months to complete.

The firm stated that the draft report is 32 pages long and contains some 70 findings. The draft report contained nine findings, although several findings identified multiple issues.

Our standard process is to provide 15 days for a firm to respond to the draft report. At the firm's request, we granted the firm a 3-day extension, for a total of 18 days. As the firm should be familiar with its audit working papers, procedures performed, and conclusions reached, we considered this time period to be sufficient for the firm to respond to the draft report.

During the review process, we were not contacted by the firm's audit staff, nor were we asked to contact anyone at the firm. From our initial attempts to contact the firm through the issuance of the draft report, only the firm's attorney communicated with us. We communicated regularly with the firm's attorney regarding the progress of our review, and he relayed information to and from the firm. The attorney was prompt in responding to our phone calls and e-mails, and we agree that in this aspect, the process was satisfactory. It was not until after the draft report was issued that the firm contacted us directly to acknowledge its receipt of the draft report and the response due date. However, the attorney requested the response extension and exit conference.

The firm is incorrect that the SCO chief auditor (Bureau Chief) advised them that she would not be available until after Thanksgiving for a meeting. On October 29, 2010, the attorney proposed a meeting after November 16 because he was out of the country. The Bureau Chief indicated that, due to other work commitments, the meeting could probably not be held until after Thanksgiving. This would have delayed the firm's response by at least an additional two to three weeks.

Further, the firm is incorrect in stating that the Bureau Chief did not return two of the attorney's calls. On November 2, 2010, the attorney and Bureau Chief had another conversation regarding the exit conference and extension. The attorney left another voicemail on November 4, 2010, requesting the SCO to reconsider the firm's request. The Bureau Chief was out of the office for most of the next two business days and returned the attorney's call (left a voice mail) when she returned to the office. The attorney did not return her phone call.

The firm states that it has quickly and completely responded to every request for information from the SCO, and has been completely cooperative. However, as noted above, the firm did not respond to our initial contacts, and it chose not to meet with us at the scheduled entrance conference. We agree however, that the firm provided the laptop containing the working papers to our office as proposed and responded to additional requests for information promptly.

The firm states that it is very concerned about the time frame provided to respond to the draft report; however, as noted above, this is our standard process, and as the firm should be familiar with its audit working papers, the time period is reasonable. When we became aware that the firm's attorney would be out of the country, we expedited our process to ensure that the draft report was issued prior to his departure. We were not aware of when the attorney was scheduled to return. In addition, we have not refused to meet with the firm. However, as previously noted, we did not believe that an exit conference would have served any purpose at the time the draft report was issued, except to delay the firm's written response to our findings. Again, the exit conference referred to in the engagement letter was proposed anticipating that an entrance conference would be initially held and the subsequent fieldwork would be conducted at the firm's office. Instead, the firm's attorney proposed an alternative quality control review process.

We are not aware of any comments made by SCO officials to the press concerning the firm or its audit. We are aware that the draft report is confidential, and have not released any information related to the quality control review, or results to the public.

The firm states that it protests our positions and the limitations we have placed on the firm with respect to its response. However, as noted, we believe the response time provided was reasonable. In addition, the firm had the opportunity to provide additional information and documentation in response to the draft report, which we have taken into consideration.

SUMMARY OF FINDINGS:

Noncompliance With Fieldwork Standards for Financial Audits

Finding 1—Audit documentation and evidence deficiencies

Our finding and recommendation remain unchanged. However, the deficiency in the payroll section was modified to remove the reference to the fraud brainstorming session.

Finding 2—Deficiencies in the firm's consideration of the risk of fraud in a financial statement audit

The deficiency regarding the firm's fraud brainstorming session has been removed. Our finding and recommendation have been revised based on the additional information provided by the firm.

Finding 3—Deficiencies in evaluating and documenting going concern

Our finding and recommendation remain unchanged.

Finding 4—Deficiencies in documentation and evaluation of subsequent events

The deficiency regarding the date of the auditor's report has been removed. Our finding and recommendation have been revised based on additional information provided by the firm.

Finding 5—Deficiencies in identifying litigation, claims, and assessments

Our finding and recommendation remain unchanged.

Noncompliance With OMB Circular A-133 Requirements

Finding 6—Deficiencies in testing federal program compliance requirements

The deficiencies regarding financial reporting and special tests and provisions have been revised based on the additional information provided by the firm. New federal testing deficiencies were added based on information provided and comments made at the December 3, 2010 exit conference. Our recommendation remains unchanged.

Finding 7—Deficiencies in evaluating internal controls over major federal programs

The deficiencies regarding eligibility and financial reporting have been removed. Our recommendation has been revised to address the use of dual purpose tests and sample size.

Noncompliance With Redevelopment Agency Audit Guide Requirements

Finding 8—Audit documentation and evidence deficiencies

Our finding was revised to clarify that the firm's audit report did not include a finding that the RDA was on the sanction list. Our recommendation remains unchanged.

Finding 9—Noncompliance with RDA Audit Guide

Our finding and recommendation remain unchanged.

SCO Comments to MHM's December 8, 2010 Letter

In a December 17, 2010 letter MHM retracted the separate communication from Garrett & Tully P.C. dated December 8, 2010.

OBJECTIVE OF A FINANCIAL STATEMENT AUDIT VS. THE OBJECTIVE OF A FRAUD AUDIT

The firm's letter of December 8, 2010, does not address the fact that the auditor also had an objective, as part of a single audit of a governmental entity, to determine compliance with laws, regulations and accountability to the public for the prudent management of government resources. The firm's audit report stated that it performed the audits of the City of Bell and the Bell Redevelopment Agency in accordance with government auditing standards. According to GAGAS 2.07, a distinguishing mark of an auditor is acceptance of responsibility to serve the public interest. This responsibility is critical when auditing in the government environment. GAGAS embody the concept of accountability for public resources, which is fundamental to serving the public interest. Further, AU 317.24 discusses an auditor's responsibilities in other circumstances. It states, in part:

> An auditor may accept an engagement that entails a greater responsibility for detecting illegal acts than that specified in this section. For example, a governmental unit may engage an independent auditor to perform an audit in accordance with the Single Audit Act of 1984. In such an engagement, the independent auditor is responsible for testing and reporting on the governmental unit's compliance with certain laws and regulations applicable to Federal financial assistance programs. . . .

Not only does GAGAS 2.07 discuss the auditor's responsibility to serve the public trust, GAGAS 2.13 emphasizes the public's expectations of auditors who serve the public interest.

GAGAS 2.13 states:

> As accountability professionals, accountability to the public for the proper use and prudent management of government resources is an essential part of auditors' responsibilities. Protecting and conserving government resources and using them appropriately for authorized activities is an important element in the public's expectations for auditors.

The findings and deficiencies noted in this report may cause the public to question whether the firm complied with government audit standards for professional behavior and professional judgment.

GAGAS 2.15 states:

> High expectations for the auditing profession include compliance with laws and regulations and avoidance of any conduct that might bring discredit to auditors' work, including actions that would cause an objective third party with knowledge of the relevant information to conclude that the auditors' work was professionally deficient. Professional behavior includes auditors' putting forth an honest effort in performance of their duties and professional services in accordance with the relevant technical and professional standards.

GAGAS 3.32 states:

> Professional judgment includes exercising reasonable care and professional skepticism. Reasonable care concerns acting diligently in accordance with applicable professional standards and ethical principles. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of evidence. Professional skepticism includes a mindset in which auditors assume neither that management is dishonest nor of unquestioned honesty. Believing that management is honest is not a reason to accept less than sufficient, appropriate evidence.

We evaluated MHM's compliance with audit standards on whether the firm's working papers complied with audit standards. As part of our evaluation of the firm's compliance with all general, fieldwork, and reporting standards, if a matter was identified in the various audits performed by SCO, we examined the firm's working papers for that area to determine what procedures it performed in that area. We did not assume, if the firm failed to identify these matters, the firm had automatically violated an audit standard. However, as discussed in Findings 1, 2, 8, and 9, the lack of audit documentation, evidence, and limited testing contributed to our conclusion.

SCO CONSIDERED DIFFERENCES OF OPINION IN PROFESSIONAL JUDGMENT AS NON-COMPLIANCE WITH PROFESSIONAL STANDARDS

MHM did not specify what additional tests we stated would have identified problems in certain areas. During the exit conference we discussed that multiple tests in multiple areas that are typically performed in an audit were not performed; therefore, we cannot determine which two additional tests MHM is referencing. MHM did not document its reason for not performing audit procedures that are commonly performed, such as review of employment agreements, testing aged receivable items, or agreeing salary expenses to payroll registers.

GAGAS 3.38 requires that auditors document significant decisions affecting the audit objectives, scope and methodology; findings; conclusions; and recommendations resulting from professional judgment.

GENERAL COMMENTS REGARDING AUDIT DOCUMENTATION

The firm's belief that the totality of work performed meets audit standards conflicts with the deficiencies described in the findings contained in our report.

AU 339.04 states:

> Audit documentation is an essential element of audit quality. Although documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate documentation contributes to the quality of an audit.

AU 339.05 states, in part:

> Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. . .

The firm argues that the findings and deficiencies noted were merely the result of lack of audit documentation. However, its argument is contrary to the requirements in state law. Specifically, Section 5097 of the California Business and Professions Code stipulates:

> (a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.
>
> (b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.
>
> **(c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence. [Emphasis added]**

At the exit conference and in this letter, the firm requested an explanation of how we concluded that it had not complied with the majority of audit standards. Our conclusion has been, and remains, that the firm's audits of the City of Bell and Bell Community Redevelopment Agency were performed in accordance with some of the standards and requirements as set forth in government audit standards, OMB Circular A-133, and the Redevelopment Agency (RDA) Audit Guide. However, the firm did not comply, to varying degrees, with the majority of fieldwork auditing standards with regard to audit documentation, audit evidence, risk of fraud, litigation, claims and assessments, subsequent events, going concern, and OMB Circular A-133 requirements for testing federal program internal control and compliance.

We determined that the firm did not comply, to varying degrees, with 13 of the 17 (or 76.5%) applicable AICPA fieldwork standards.

As requested by the firm, following is a listing of the audits standards and requirements with which the firm failed to comply:

1. AU 311 – Planning and Supervision – Findings 1 and 6
2. AU 312 – Audit Risk and Materiality in Conducting an Audit – Finding 1
3. AU314 – Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement – Finding 2
4. AU 316 – Consideration of Fraud in a Financial Statement Audit – Finding 2
5. AU 317 – Illegal Acts by Clients – Objective of a Financial Statement Audit versus Objective of a Fraud Audit
6. AU 318 – Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained – Finding 1
7. AU 326 – Audit Evidence – Finding 1
8. AU 329 – Analytical Procedures – Finding 1
9. AU 333 – Management Representations – Finding 1
10. AU 337 – Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments – Finding 5
11. AU 339 – Audit Documentation – Findings 1, 3, 4 and 6
12. AU 341 – The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern – Finding 3
13. AU 350 – Audit Sampling – Findings 1, 3, and 6

We determined that the firm complied with 4 of the 17 (23.5%) applicable fieldwork standards as follows:

1. AU 325 – Communicating Internal Control Related Matters Identified in an Audit
2. AU 330 – The Confirmation Process
3. AU 334 – Related Parties
4. AU 380 – The Auditor's Communication with those Charged with Governance

We determined that the following standards were not applicable to the audits we reviewed:

1. AU 315 – Communication between Predecessor and Successor Auditors
2. AU 322 – Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements
3. AU 324 – Service Organizations
4. AU 328 – Auditing Fair Value, Measurements and Disclosures
5. AU 331 – Inventories
6. AU 332 – Auditing Derivative Instruments, Hedging Activities, and Investments in Securities
7. AU 336 – Using the Work of a Specialist
8. AU 342 – Auditing Accounting Estimates
9. AU 390 – Consideration of Omitted Procedures after the Report Date

In addition, we determined that the firm did not comply, to varying degrees, with these AICPA non-fieldwork standards:

1. AU 110 – Responsibilities and Functions of the Independent Auditor – Finding 2
2. AU 560 – Subsequent Events – Finding 4

Government Audit Standards

We determined that the firm did not comply, to varying degrees, with the following government audit standards.

GAGAS 2.07 – The Public Interest – Objective of a financial statement audit vs. the objective of a fraud audit
GAGAS 3.32 – Professional Judgment – Objective of a financial statement audit vs. the objective of a fraud audit
GAGAS 3.38 – Professional Judgment– Finding 1
GAGAS 4.19 – Audit Documentation – Findings 1, 5, and 9
GAGAS 4.25 – Additional Considerations for GAGAS Financial Audits – Finding 1
GAGAS 4.26 –Materiality in GAGAS Financial Audits – Finding 1
GAGAS 4.28 – Consideration of Fraud and Illegal Acts – Finding 8

Finally, the firm did not comply, to varying degrees, with the following federal and state audit requirements:

OMB Circular A-133 - Audits of States, Local Governments and Non-Profit Organizations – Findings 6 and 7
California Redevelopment Agency Audit Guidelines – Findings 8 and 9
California Business and Professions Code 5097 – Findings 1 through 9

SUPPLEMENTAL INFORMATION

We offer the following comments to the firm's "additional significant information:"

Finding 1

- The City of Bell's balance sheet reported receivables in four different categories– accounts receivable, accrued interest receivable, deferred loans receivable, and loans receivable. The firm may have tested items reported as accounts receivable but, as stated in our finding, there was no documentation or evidence that the auditor verified the age or collectability of a $300,000 loan, which was 99.87% of the $300,385 loans receivable shown on the city's balance sheet.

- The 36% current year additions that the firm examined for support consisted of one addition of land purchased for $4.8 million. The auditor reviewed the journal entry that recorded the promissory note of $4.6 million as well as the promissory note. As discussed in our finding, the auditor did not note the $200,000 difference between the land's purchase price and the asset recorded value. The tests

performed failed to confirm the financial statement assertions of existence, rights, and valuation. The firm has not addressed the procedures it performed to verify that the city's list of capital asset additions was complete.

- The firm's testing of payroll internal controls consisted of determining that:
  - One payroll register was verified against the check register as evidenced by city management staff initials
  - Payroll changes listed on the payroll change report were supported by personnel action forms signed by management as evidence of approval and that the change was made in the payroll master file
  - Employees who had password access to the payroll master file did not process the payroll

The firm also tested payroll accruals and the related payroll tax liability. However, the firm's audit procedures were not adequate to test the financial statement assertions of completeness, obligation, allocation, presentation and valuation. Further, the firm's review of receivable support and disbursement transactions could not be expected to disclose errors in assertions of occurrence and allocation in the payroll account because all transactions were posted in the payroll and related accounts.

Contracts, Grants and Laws

- Our finding was that there was no information in the firm's working papers that identified which grants, laws, ordinances, etc. the auditor considered when designing the audit procedures. The "dashboard" summary provided by the firm shows prepared-by (performed-by) dates that are inconsistent with the firm's audit program. The dashboard summary shows a prepared-by date of January 20, 2010 while the audit program shows a performed-by date of December 19, 2009.

  The dates that testing was performed regarding bond compliance, investment compliance, Constitution Article 13B testing, redevelopment compliance testing, and grant compliance testing do not provide evidence that the firm considered all applicable grants, laws, ordinances, etc. in designing its audit procedures.

Finding 3

It appears that the firm has misinterpreted our finding. We clearly stated that:

> Based on the working papers, we cannot determine whether the firm evaluated the city's ability to meet its obligations for normal operations, as well as the debt service payments on its $150 million in long-term liabilities.

Finding 5

The firm does not make clear that it contacted only one legal counsel, whom the firm described as the City's attorney. The firm relied on this one attorney's assertion on litigation, claims, and assessments because the firm stated that it constituted third party audit evidence. The firm did not explain how it determined that this outside legal counsel (who was not employed by the City) would have complete knowledge of all of the city's litigation, claims, and assessments. In addition, the firm did not explain why it failed to obtain a legal representation letter from an attorney who was paid $427,000 for legal services during fiscal year 2008-09.

Finding 6

- Since the firm did not document that it determined whether the city had a loan origination and servicing system in effect, there is no assurance that the firm identified all program income for fiscal year 2008-09. As the firm did not document the scope of its testing, we were unable to determine which accounts and funds the auditor reviewed to identify program income.

- We agree that the Federal Form SF 272 was not applicable to the City of Bell and revised the finding, accordingly.

Finding 8

The information provided by the firm was not documented in the firm's working papers. It appears that the firm was not aware that the redevelopment agency was sanctioned and therefore, did not perform any audit procedures or analysis as required by the Guidelines for Compliance Audits of California Redevelopment Agencies.

Noncompliance With Fieldwork Standards for Financial Audits

FINDING 1—
Audit documentation and evidence deficiencies

Our review of the firm's working papers disclosed audit documentation and evidence deficiencies in the following areas:

Analytical Procedures

The firm performed analytical procedures in planning the audit to determine the nature, timing, and extent of the audit procedures to be performed. The auditor compared prior year balances per the audited financial statements with the current year trial balance for all revenue and expenditure accounts that were greater than $400,000. The auditor documented the variances between the current and prior fiscal year and requested city management's explanation for variances in excess of $200,000 and 15%.

The firm documented the expectations, as noted above, but the firm did not document that it considered all relevant factors in establishing the materiality levels used in performing the analytical procedures. Government auditing standards require the auditor to consider other factors in establishing materiality levels. For example, auditors may find it appropriate to use lower materiality levels compared with the materiality levels used in non-GAGAS audits because of the public accountability of government entities, various legal and regulatory requirements, and the visibility and sensitivity of government programs. In addition, auditing standards require the auditor to consider qualitative as well as quantitative factors when assessing materiality, such as whether large-dollar activities or balances might distort quantitative materiality for the audit.

The firm relied on the same analytical procedures to conclude that the financial statements were fairly stated instead of performing additional substantive tests. As discussed in the Accounts Receivable, Capital Assets and Payroll sections of this finding, by using primarily analytical procedures as substantive tests, the firm did not obtain assurance on all of the relevant financial statement assertions of existence and occurrence, valuation or allocation, presentation or disclosure and completeness.

AU 329.10 states:

> The auditor considers the level of assurance, if any, he wants from substantive testing for a particular audit objective and decides, among other things, which procedure, or combination of procedures can provide that level of assurance. For some assertions, analytical procedures are effective in providing the appropriate level of assurance. For other assertions, however, analytical procedures may not be as effective or efficient as tests of details in providing the desired level of assurance.

AU 329.22 states:

> When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor should document all of the following:
>
> *a.* The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development
> *b.* Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts
> *c.* Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.

GAGAS 4.26 states, in part:

> . . .Additional considerations may apply to GAGAS financial audits of government entities or entities that receive government awards. For example, in audits performed in accordance with GAGAS, auditors may find it appropriate to use lower materiality levels as compared with the materiality levels used in non-GAGAS audits because of the public accountability of government entities and entities receiving government funding, various legal and regulatory requirements, and the visibility and sensitivity of government programs.

FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information,* defines materiality as:

> The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

In addition, our review disclosed audit documentation and evidence deficiencies in the following areas:

Cash and Investments

The amounts reported in the financial statements did not agree to the working papers. The working papers identify $42,670,414 in cash and investments; however, the Balance Sheet reported $42,674,731 and the Statement of Net Assets reported $42,674,729, which reflect variances of $4,317 and $4,315, respectively. Even though the variances between the working papers and the audited financial statements did not exceed the materiality limits, the firm did not document or explain the variances or the disposition of the variances.

Receivables

The firm's Loan Receivable Reconciliation working papers showed a $300,000 loan receivable that was at least one year old (outstanding as of June 30, 2008, and no activity during FY 2008-09). There was no evidence that the auditor verified the age of the loan receivable or attempted to confirm collectability, which is a common audit procedure

in testing the financial statement assertions of existence, rights, and valuation. The SCO's audit on the city's Administrative and Internal Accounting Controls, issued in September 2010, disclosed that $300,000 was loaned to a business entity in the city, apparently without knowledge or consent of the city council. The loan currently is in default.

In addition, the amount reported on the Balance Sheet for Non-Major Governmental Funds was not supported by the working papers. The working papers identify $20,446 in accounts receivable for non-major governmental funds; whereas, the Balance Sheet reported $41,018, which reflects a variance of $20,572. The firm indicated that the cause of the variance was due to the city's classification of a $20,572 rent receivable as an accounts receivable. However, this explanation was not documented in the working papers. Even though the variances between the working papers and the audited financial statements did not exceed the materiality limits, the firm did not document or explain the variances or the disposition of the variances in the working papers.

Capital Assets

The firm tested capital assets by analyzing the city's supporting analysis of capital assets which showed, by major class of capital assets, the beginning balance, additions, deletions, and ending balance. The firm also analyzed the city's supporting schedules for capital asset additions. Based on the work it performed, the firm concluded that no additional audit work was necessary because the analytical procedures did not identify, and the supporting schedules did not indicate, a risk or any other evidence of material misstatement.

The analytical procedures performed did not provide assurance on the following financial statement assertions – existence, rights and valuation. The SCO audit issued in September 2010 noted that the city purchased real property for $4.8 million in May 2009. The city's Summary of Capital Assets shows an addition of a building to the Community Redevelopment Agency (CRA) assets of $4.6 million. This addition is supported by a detail schedule showing capital asset additions. If the firm had performed procedures to verify the valuation and existence of the building, it should have discovered that the asset was undervalued by $200,000. In addition, if the firm had reviewed the property appraisal (which is used to confirm the value of the building) it should have noted that the appraisal was dated May 30, 2008 – a year prior to the purchase of the building.

The firm's audit program for capital assets required the auditor to evaluate capital asset impairments. The auditor noted on the audit program, "No impairments detected"; however, the working papers did not contain evidence to support how the auditor arrived at this conclusion. As discussed in Finding 4—Deficiencies in documenting and evaluating subsequent events, in the summer of 2008, a judge invalidated a 30-year option to lease between the City of Bell and a railway because the city had not obtained an environmental review prior to signing the option to lease. The judge also blocked a 45-year extension of an existing lease that permitted the railway to continue using city-owned property.

The judge's decision impacted the service utility of the property (i.e., fair market value), which is the usable capacity that, at acquisition, was expected to be used to provide service; therefore, the city should have reported the assets at the lower of carrying value or fair market value. The firm's inquiries of management and others within the city, or review of the governing board minutes, should have disclosed the possible impairment of capital assets.

In addition, the audit documentation did not indicate whether the firm verified that the city's list of capital assets additions was complete and did not document that it determined the city's compliance with laws or regulations governing the disposal of assets.

Payroll

The firm primarily tested payroll using analytical review procedures as described at the beginning of this finding. As a result of this approach, it appears that the firm limited its payroll testing to approximately $3.7 million in payroll expenditures from the General Fund. There was no evidence that payroll from other funds, such as the Solid Waste and Recycling Authority, Surplus Property Authority, Public Housing Authority, and Community Housing Authority were reviewed. In addition, we were unable to determine if the $3.7 million tested by the firm was representative of total city payroll and provided sufficient evidence for the firm to conclude that payroll expenditures were fairly stated and financial statement assertions of completeness, valuation and allocation were tested.

We also noted the following deficiencies in the payroll testing:

The SCO's September 2010 audit disclosed that the Chief Administrative Officer (CAO) received compensation in excess of $1 million. The $1 million compensation was allocated to multiple funds and accounts during FY 2008-09. This was not identified in the firm's analytical review for further investigation as directed by the audit procedure.

Furthermore, the CAO's employment agreements with the Solid Waste and Recycling Authority, Surplus Property Authority, Public Housing Authority, and Community Housing Authority, all effective on September 1, 2008, provided for an adjustment to his basic salary based on a positive fund balance in the city's General Fund. If the firm had reviewed the employment agreements for key employees, it should have noted that the CAO's basic salary would increase if the city's General Fund maintained a positive fund balance. This stipulation increased the incentive and risk for misappropriation of funds. We also noted that the firm did not consider these employment agreements and their impact on risk assessment. (See Finding 2—Deficiencies in the firm's consideration of risk of fraud in a financial statement audit).

Had the firm performed other substantive procedures such as reconciling payroll registers with payroll expenditures reported, or reviewing general ledger accounts for unusual activity, it should have noted that public funds were being advanced to city employees. The advances, as well as principal and interest payments, were reported in the Paid In Lieu of Vacation account. In our review of the city's 2008-09 general ledger, we noted a total of 12 employees received advances which totaled more than $500,000. The advance amounts ranged from $3,000 to $130,000.

A procedure in the firm's audit program required the auditor to identify bonuses or other unusual compensation, and inspect evidence of approval. A comment on the program noted that the auditor discussed bonuses with city personnel, and determined that no material or large bonuses were given. However, the auditor did not review expenditures or contracts to identify bonuses, or perform other procedures to verify the statements of city personnel.

One payroll item tested as part of the firm's analytical review met, but did not exceed the established materiality levels of $200,000 and 15%. However, because it did not exceed the established materiality levels, the auditor simply accepted the explanation from city management and performed no further work.

Consideration of Contracts, Grant Agreements, Laws and Regulations

The audit program for review of minutes, contracts, ordinances, and laws was signed off as being completed on December 19, 2009, which was after the Report on Compliance and Other Matters and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards, that was dated December 18, 2009.

The auditor indicated as "Done" on December 19, 2009, regarding the following basic audit procedures:

- Obtain and review abstracts or copies of new agreements and new amendments to existing agreements
- Review charter to determine duties, powers, and other data relevant to the audit
- Review the administrative code and ordinances enacted in the current year
- Review general state statutes to the extent considered necessary

There was no information in the firm's working papers that identified which grants, laws, ordinances, etc., the auditor considered when designing the audit procedures. In addition, based on the sign-off date of December 19, 2009, it appears the auditor performed these procedures in concluding the audit, but not in planning the audit as required by AU section 317.

AU section 317 and GAGAS 4.28 require the auditor to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from illegal acts (that is, violations of laws and regulations) that have a direct and material effect on the determination of financial statement amounts. This involves identifying the laws and regulations that may have a direct and material effect on the financial statement amounts, and then assessing the risk that noncompliance with these laws and regulations may cause the financial statements to contain a material misstatement.

AU section 339.10 states:

> The auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand:
>
> *a.* The nature, timing, and extent of auditing procedures performed to comply with SASs and applicable legal and regulatory requirements;
>
> *b.* The results of the audit procedures performed and the audit evidence obtained;
>
> *c.* The conclusions reached on significant matters; and
>
> *d.* That the accounting records agree or reconcile with the audited financial statements or other audited information.

AU section 326.35 states, in part:

> The auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient appropriate audit evidence to detect a material misstatement at the relevant assertion level.

GAGAS 4.19 states, in part:

> Under AICPA standards and GAGAS, auditors should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand
>
> a. the nature, timing, and extent of auditing procedures performed to comply with GAGAS and other applicable standards and requirements…

GAGAS 4.25 states, in part:

> Due to the audit objectives and public accountability of GAGAS audits, there may be additional considerations for financial audits completed in accordance with GAGAS. These considerations relate to
>
> a. materiality in GAGAS financial audits…
>
> b. consideration of fraud and illegal acts…
>
> c. ongoing investigations or legal proceedings…

GASB 42, paragraph 5 states:

> Asset impairment is a significant, unexpected decline in the service utility of a capital asset. Governments generally hold capital assets because of the services the capital assets provide; consequently, capital

> asset impairments affect the service utility of the assets. The events or changes in circumstances that lead to impairments are not considered normal and ordinary. That is, at the time the capital asset was acquired, the event or change in circumstance would not have been expected to occur during the useful life of the capital asset.

GASB 42, paragraph 8 states, in part:

> The events or changes in circumstances affecting a capital asset that may indicate impairment are prominent – that is, conspicuous or known to the government. . . . The events or circumstances that may indicate impairment generally are expected to have prompted discussion by the governing board, management, or the media.

GASB 42, paragraph 9, states, in part:

> Impairment is indicated when events or changes in circumstances suggest that the service utility of the capital asset may have significantly and unexpectedly declined. Common indicators of impairment include:
>
> b. Enactment or approval of laws or regulations or other changes in environmental factors. . . .

As the firm did not obtain sufficient appropriate evidence by performing suitable audit procedures, the firm's conclusion that the financial statements fairly represent the city's financial position may not be appropriate.

Recommendation

The firm should comply with audit standards as follows:

- Consider and document all relevant factors in establishing materiality levels used in performing analytical procedures.
- Ensure that amounts reported on the financial statements are supported by the working papers.
- Perform audit procedures to:
  - Verify outstanding loan receivables.
  - Verify material capital asset impairments and additions.
  - Determine compliance with laws and regulations governing disposal of assets.
  - Verify evidence obtained by inquiry.
  - Identify incentives for misappropriation of funds.
- Ensure that all relevant financial statement assertions are tested.
- Identify, document, and test compliance with laws and regulations that may have a material effect on the financial statements.

Firm's Response

ANALYTICAL PROCEDURES

The draft state controller's report was incorrect in suggesting that we did not follow Generally Accepted Government Auditing Standards (GAGAS) and U.S. generally accepted auditing standards with respect to the establishment of planning materiality and the use of analytical procedures.

With respect to planning materiality, the state controller's report cited GAGAS 4.26 which indicates that additional considerations may apply to GAGAS financial audits of government entities.

It should be noted that the citation quoted in the state controller's report (GAGAS 4.26) uses the permissive sense ("may find it appropriate to use lower. . ."), rather than the prescriptive sense. This means that after such consideration, the auditor may or may not find it appropriate to lower his or her planned materiality threshold based upon the relevant facts and circumstances known to the auditor during the risk assessment. The issues relevant to an adjustment of planning materiality are the same issues that were documented in 3-5B with respect to the entity and activity level internal control environment of the City. When developing our planning materiality, the issues at 3-5B were known to the audit team and considered by our firm as to the appropriateness of adjusting our planned materiality thresholds. Our documentation in this workpaper indicates that we assessed during the planning stage of our audit that there were no unusual issues of fraud risk, political sensitivity, or legal or regulatory compliance that was known to the engagement team to warrant a change in our planned materiality thresholds. In fact, at the time that the 2009 audit was performed, there was no evidence of the issues that later became disclosed in 2010. Our considerations were documented at workpaper 3-5B and did not warrant the need to adjust our planned materiality thresholds. This is an issue of professional judgment that was properly considered and determined by our firm based on the facts and circumstances available at that time and reasonable conclusions were reached with respect to this issue.

MHM, in fact, considers the uniqueness of the government environment to determine materiality on its governmental audits. On governmental entities, MHM determines materiality on an opinion unit basis which is different than the process used to determine materiality for non-GAGAS or for-profit entities. Determining materiality by opinion unit forces lower levels of materiality for governmental audits as specified by GAGAS 4.26.

The draft state controller's report suggested that we did not consider qualitative aspects when assessing materiality. We disagree with SCO conclusion regarding consideration of qualitative aspects considered in assessing materiality for the City of Bell audit.

Our workpaper documentation at workpaper 3-11 documents clearly our consideration of qualitative aspects in assessing our planning materiality. In workpaper 3-11, we documented our consideration, as follows:

> In determining planning materiality, auditors can consider whether qualitative factors may distort quantitative measures. If this is the case, auditors may choose to eliminate certain large dollar items from the calculation and set separate planning materiality levels for the excluded items and for the remaining items.

The decision was made by our audit team that we would intentionally and deliberately exclude capital assess from our consideration of planning materiality because the large dollar balances of capital assets might distort our consideration of planning materiality with respect to the City's audit.

It should be noted that the threshold use for selection of balances to be subjected to our analytical procedures was 2/10 of one percent of the total assets of the City.

The state controller's draft report also suggested that the firm relied on the same analytical procedures to conclude that the financial statements were fairly stated instead of performing other substantive tests. The standards and facts indicate that the SCO's suggestion is inaccurate.

AU 329.22 states:

> When an analytical procedure is used as the principle substantive test of a significant statement assertion, the auditor should document all of the following:
>
> a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed and factors considered in its development [this was documented at workpaper 3-10]
>
> b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts [this was documented at workpaper 3-10]
>
> c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedures and the results of such additional procedures [no unexpected differences were identified]

As discussed further below, we did not rely solely on analytical procedures with respect to the relevant financial statement assertions for Accounts Receivable, Capital Assets, and Payroll (existence and occurrence, valuation or allocation, presentation or disclosure and completeness), as suggested by the draft state controller's report. In fact, for each of those areas, a number of additional procedures were performed.

For example, for accounts receivable, assertions of existence valuation and presentation were addressed as follows: Per workpaper D-1, using auditor's judgment, we vouched certain individually significant items that were reflected in receivable balances to evidence of subsequent collection. For the disclosure assertion, we utilized our firm's disclosure checklist. Analytical procedures were only relied upon for the completeness assertion. The responses to our analytical procedures did not indicate a heightened risk of material misstatement with respect to accrued revenues that warranted, much less required, further testwork.

For Capital Assets and Payroll, see the discussion below of the audit procedures in addition to the analytics that were performed and addressed material assertions relevant to those audit areas.

It should be noted that professional standards do not require the auditor to test all assertions relative to an account balance or transaction class. The standards require the auditor to assess the risk of misstatement inherent in each of the relative assertions and design procedures accordingly, but there is no requirement to test all assertions related to each account balance or to test them to the same level of confidence.

CASH AND INVESTMENTS

We disagree with the SCO conclusion that our audit testing for cash and investments was inadequate due to a very minor ($4,317) variance that existed in cash and investments between our audit support and the recorded cash and investments by fund that was not pursued for further investigation due to its extreme immateriality. We disagree with the SCO conclusion that our documentation was inadequate pertaining to the disposition of this small variance. Based upon the extensive audit tests completed in cash and investments, meeting the existence, valuation and completeness assertions, we documented that "the difference is relatively insignificant and MHM passed on further testwork". This variance was less than one-tenth of 1% of the City's total cash and investment balances at June 30, 2009 of $47,872,843. The City's total assets at June 30, 2009 were $193,052,545. It is inaccurate to suggest as the draft SCO report does that the scope of an audit requires the investigation and disposition of every unreconciled difference identified in the City's books and records, especially when the amount is clearly inconsequential and immaterial to the financial statements that we were engaged to audit.

ACCOUNTS RECEIVABLE

We disagree with the SCO conclusion that our audit documentation was inadequate with respect to a receivable in the amount of $300,000. This transaction was made in the fiscal year ended June 30, 2008 and we reviewed the underlying audit documentation in that fiscal year (See Attachment #3). Our audit tests documented that, in the general fund, this $300,000 asset was offset by an equal amount in deferred revenue (a liability), similar to a rehabilitation loan. Since this loan receivable was fully off-set by deferred revenue in an equal amount recorded in the City's liabilities, there was no risk of misstatement with respect to the fund balance of the general fund. Due to the dollar amount involved, the recent nature of the transaction, this loan's effect on fund balance of the fund, and in consideration of the documentation examined at the time of issuance, we believe that sufficient audit evidence was obtained to support all relevant financial statement assertions for this item.

As noted in the State Controller's Draft Report, the financial statements of the City presented accounts receivable reported in the non-major funds at a dollar amount of $41,018. The analysis provided by the client addressed detailed support for $20,446 of the $41,018 balance reported in the financial statements. This difference of $20,572 was not material. As previously stated, it is inaccurate to suggest that the scope

of an audit requires the investigation and disposition of every unreconciled difference identified in the City's books and records, especially when that amount is clearly inconsequential and immaterial to the financial statements that we were engaged to audit.

CAPITAL ASSETS

We disagreed with the SCO conclusion that inadequate substantive audit testing was performed in capital assets. In workpaper 3-7A, we clearly reviewed as a part of our journal entry analysis and review of documentation for the building purchased by the Community Redevelopment Agency for the Deeds of Trust for 6415/6425 and 6501 Atlantic Blvd. These audit procedures were performed in addition to our analytical review of capital assets. Our workpapers clearly demonstrate that the assertion of existence, ownership, rights and valuation were tested. The above procedures documented in our workpapers demonstrated that the Capital Asset was acquired on May 21, 2009. The City did not inform the auditor that an appraisal had been performed in conjunction with this transaction. For the purpose of preparing local government financial statements, an asset's value is determined by the cost incurred (cash paid plus indebtedness incurred) to obtain the asset (otherwise known as the "historical cost basis"). The appraised value of a property is irrelevant for purposes of determining the initial amount of the asset to record (i.e., the historical cost incurred by the City to acquire the property) for the City acquired asset. Our testing for this transaction was performed during our routine testing of journal entries that were reflected in the City's accounting system. One of the journal entries tested in that phase of our field work represented the recording of the proceeds of debt that was incurred to acquire this property. As a part of our journal entry testing, we reviewed this entry and related support. $200,000 of cash was also contributed toward this property transaction in a separate entry recorded in the accounting system of the City in the previous fiscal year. The entry for the $200,000 cash portion of the purchase was not selected during our journal entry testing due to the immateriality of the entry (less than 1% of total City expenditures) and that it occurred in the previous fiscal year. The documentation for the recorded cost of these buildings was $4,600,000. This capital addition that was tested during our journal entry testing also represented 36% of the capital additions of the City for the year. It should be noted that for assets, the significant audit risk is the risk of overstatement, not understatement, and as such additional procedures to test the completeness assertion were not considered necessary given the nature and extent of the other assertions tested and procedures performed.

We disagree with the SCO conclusion that inadequate auditing was done on capital asset impairments. Our audit program conclusion of "no impairments detected" was documented through the auditor performing tests of capital assets and inquiry of client personnel. The City's Senior Accountant interacted with the auditors and provided that response for the documentation. Further, in our written representation letter at workpaper 4-9, 2 signed by the former CAO (Robert Rizzo) and the Director of Administrative Services (DAS) (Lourdes Garcia) (Attachment No. 9) the City represented that it has no plans that would materially affect the carrying value or classification of assets. Additionally, in our subsequent events audit documentation, our senior auditor inquired and documented on December 19, 2009, with the City's Senior Accountant and Director of Administrative Services

whether there were any events that occurred that caused a decline in the value of any assets. While the SCO believes that our inquiries, review of minutes and client representations should have disclosed a possible impairment, they did not, because of responses and documentation provided during our audit process. Moreover, our minutes review at workpaper 4-2A disclosed that the minutes did not discuss any legal invalidation of the lease between the City and the Railway and Environmental issues that would have surfaced as potential impairment issue. Further, the attorney letter responses from the City Attorney, Edward Lee of Best, Best & Krieger to auditor inquiries regarding potential legal issues (at workpaper 4-3B), dated October 8, 2009 and updated on December 22, 2009 (Attachment #6) did not have any mention of this issue or the court order in which the SCO's draft report refers.

Paragraph 8 of GASB Statement No. 42 indicates:

> 8. The events or changes in circumstances affecting a capital asset that may indicate impairment are prominent—that is, conspicuous or known to the government. Absent any such events or changes in circumstances, governments are not required to perform additional procedures to identify potential impairment of capital assets beyond those already performed as part of their normal operations. The events or circumstances that may indicate impairment generally are expected to have prompted discussion by the governing board, management, or the media.

Based upon the standard of reporting impairments as defined above, our inquires with both management and legal counsel and review of the minutes were appropriate and reasonable measures to be taken during the audit process to identify "prominent impairment that was conspicuous and known to the government." The fact that the City, its attorney and its minutes did not disclose these issues indicate that it was neither prominent nor conspicuous. Therefore, there was no deficiency in the audit process with respect to this issue.

The draft State Controller's Report cited AU Section 326.35 which states that "inquiry alone ordinarily does not provide sufficient appropriate audit evidence" [emphasis added]. The use of the work "ordinarily" implies that there are some circumstances when inquiry alone would be appropriate.

The circumstances associated with asset impairment ("prominent", "conspicuous", "known to the government", "not required to perform additional procedures to identify potential impairment", etc.) represent an area of audit responsibility for which inquiry (in combination with a review of minutes) are, in fact, reasonable and appropriate auditor responses to the risk of material misstatement potentially applicable to this area of financial reporting.

Moreover, paragraph 18 of GASB Statement No. 42 specified that an asset's recorded value should not be written down unless the impairment is permanent:

> 18. Generally, an impairment should be considered permanent. In certain circumstances involving capital assets impaired through enactment or approval of laws or regulations or other

> changes in environmental factors, change in technology or obsolescence, change in manner or duration of use, or construction stoppage; however, evidence may be available to demonstrate that the impairment will be temporary. In such circumstances, the capital asset should not be written down.

A judge blocking an extension of an existing lease due to the lack of an environmental review would not necessarily create a permanent impairment in the value of an asset. The subsequent completion and submission of such an environmental review could have remedied the issue and made the impairment only temporary, and therefore not recordable. GASB Statement No. 42 paragraph 9 (b) provides a potential example of a similar situation where an impairment may be other than permanent if modifications can be met. In either event, our inquiries and procedures concerning this issue, including receipt of written representations, review of minutes and inquiring of legal counsel were appropriate, prudent and consistent with the standards governing auditing the issue of asset impairment. There was no deficiency in the audit process with respect to this issue.

We further disagree with the SCO conclusion that audit documentation was not adequate to understand and validate controls over the completeness of capital assets. We obtained evidence concerning the completeness of capital asset additions by evaluating and testing the internal controls surrounding that process (STC6-A). This assessment of internal control did not indicate the need to perform more extensive substantive procedures, such as an exhaustive search of the accounting records for capital asset additions that were not recorded. The controls over changes in capital assets were reviewed and documented at the internal control workpaper STC6-A. The City's Senior Accountant (who has previous CPA Firm auditing experience) was the preparer of the changes to capital assets and the Director of Administrative Services (DAS) reviewed the capital asset activity to insure all capital assets were appropriately reflected. The auditors obtained and reviewed the client journal entries to record additions and deletions to fixed assets reviewing that the proper key internal controls were in place over capital asset accounting.

During the year under audit, approximately $559,000 of deletions were made to capital assets. More than 90% of the deletions were infrastructure and improvements being replaced (streets, traffic signals, etc. . .) (See workpaper E-1). These deletions did not involve the disposition of assets acquired with federal funding to which federal disposition requirements would apply. We believe the foregoing facts clearly demonstrate that controls over the completeness of capital assets were very satisfactory.

PAYROLL

We disagree with the SCO conclusion that the auditors used only analytical tests in the payroll area. Analytical tests were only one test used in our audit procedures concerning payroll. We also disagree with the SCO conclusion that payroll charged to funds other than the general fund was not subjected to the analytical tests. All funds were included in the analytical tests at workpaper 3-10 (not just the General Fund, as suggested by the draft SCO report), for fluctuations of revenues and expenses for the scope established in our test, including solid waste, recycling authority, Surplus Property Authority, Public Housing Authority and Community Housing Authority Funds. The expenditure

accounts subjected to our analytical review procedures included all funds of the City. All expenditure accounts recorded in the accounting system of the City that contained a balance greater than $400,000 were analyzed as a part of our analytical review procedures (not just the General Fund, as suggested by the draft SCO report).

In addition to analytical tests that covered payroll, we also documented the process associated with payroll processing at the City of Bell at file STC4-A and generally control risk is assessed as low with respect to material misstatements associated with payroll transactions.

Our documentation of the payroll system included the following aspects of the payroll process:

- Authorization to add employees, delete employees and authorizations required on Personnel Action Forms (PAF's)
- Access to Payroll Master File
- Timesheet Reporting and Requirements
- Timesheet Approvals
- Direct Deposit and Payroll Reconciliation
- Controls over the Preparation and Approval of Payroll.
- Controls of the Payroll Account, Payroll Tax return process.

After documentation of key controls in payroll, these key controls were tested through observation and inspection as documented as workpaper STC4-C. Our auditors observed the process of approvals and tested them in accordance with AICPA Professional Standards. The population for which we did our test of controls included all employees' paychecks including the Former CAO. The foregoing was in addition to the analytical tests performed in our audit.

These tests of payroll controls, inconsideration of the relatively low risk of material misstatement associated with payroll and the performance of other substantive procedures (analytical review procedures, cut-off tests, etc.) were appropriate under the circumstances and reflected a reasonable application of professional judgment of the auditor. The SCO draft report indicated that the City Manager's salary "was not identified in the firm's analytical review for further investigation, as directed by the audit procedure" (page 8 of the draft SCO report). The reason the City Manager's salary "was no identified in the firm's analytical review for further investigation" was because his salary did not create a material variance warranting further investigation under the requirements of the analytical review process. Furthermore, it is not uncommon for a City Manager's salary to be allocated to various funds of the local government. Again, this was not an issue identified by our analytical review procedures as warranting further investigation.

In our payroll testing, the City Manager's salary was not singled out and specifically tested in the audit process because the focus of the audit process is on the risk of material misstatement and on legal issues that would have a direct and material effect on the determination of financial statement amounts.

We disagree with the SCO conclusion that there were deficiencies in the firm's consideration of risk of fraud in the financial statement audit. Specifically, we documented through observation and inquiry at workpaper 3-7 Fraud Risk Inquiries of the Director of Administrative Services and City's Senior Accountant. We also documented risks in the financial statement audit at workpaper 3-8. We also documented at workpaper 3-5c the management Anti-Fraud Programs and Controls. The entity and Activity Level Controls were thoroughly documented at workapper 3-5B (Attachment 2).

We disagree with the SCO conclusion that our audit procedures did not meet generally accepted auditing standards with respect to employee advances. Our audit procedures did include a thorough review of the trial balances. There were no employee loans receivable or advances reflected as assets on any of the City's trail balances at June 30, 2009. Further, the accounts receivable summary provided by the City's Senior Accountant reflected no employee receivables in account #125. The foregoing results of the two reviews did not raise an issue of additional risk. Further, at workpaper STC2 B-1 we performed a test of disbursement transactions and those disbursement tests did not disclose any disbursements to employees that were not properly documented and recorded nor did they indicate the existence of the unrecorded loans. As a result of these tests, we concluded that the controls were operating effectively. Furthermore, management's written representatives signed by Robert Rizzo, Chief Administrative Officer, and Lourdes Garcia, Director of Administrative Services, indicated that the financial statements reflected the recording of all related party transactions, including loans and amounts receivable from or payable to related parties (see Attachment 9). Our properly conducted testing of cash disbursements did not identify any unrecorded employee loans. AU 110.02 indicates that the audit process provides "reasonable, but not absolute assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected." Our auditing procedures conformed to this standard.

The SCO conclusion is correct that our audit program did have a step to identify bonuses or other unusual compensation. As documented at J-0A, our audit staff performed inquiries with Anna Montoya, Senior Accountant, who indicated that no material or large bonuses are given. That inquiry and response from the City's Senior Accountant and our other tests of key controls in payroll previously discussed were appropriate audit evidence. The draft SCO report indicated that the audit firm did not explicitly document discussion of the possibility of management bonuses in its brainstorming session. This is correct. The reason there was no explicit documentation of this discussion is that there was no history of paying such bonuses in the past (based upon the auditor's experience in performing audits of the City for prior fiscal years) and because this was an explicit step in our audit program that was known to be addressed in our firm's standard audit process. At the time of the brainstorming session, the audit team had no reason to identify this issue as an issue of risk unique to the Bell audit that required the performance of procedures beyond the procedures addressed in our audit program.

In should be noted that, in fact, inquiries concerning management bonuses were made during the audit process.

The draft SCO report suggest that "had the firm performed certain other substantive procedures such as reconciling payroll registers with payroll expenditures reported, or reviewing general ledger accounts for unusual activity, it should have noted that public funds were being advanced to city employees." It should be noted that these additional procedures suggested in the draft SCO report are inconsistent with predominant practice with respect to local government audits. The payroll audit program located at ALG-AP-10 in the Thomson publication entitled "PPC's Guide to Audits of Local Governments" indicates that the basic audit approach for payroll is analytical review procedures. The PPC publications are widely used reference source of the practical application of local government audits.

The additional substantive procedures suggested in the SCO draft audit report are identified by PPC as additional procedures that should only be performed where the auditor's risk assessment supports a deviation from the normal approach to auditing payroll in a local government audit, which is limited to analytical review procedures. Our risk assessment of the June 30, 2009 Bell audit did not indicate the need to deviate from established practice with respect to the audit of payroll in a local government audit (which are limited to tests of controls and use of analytical procedures).

The draft SCO report at page 9 indicated that "one payroll item tested as part of the analytical review met, but did not exceed the established materiality levels of $200,000 and 15%. However, because it did not exceed the established materiality levels, the auditor simply accepted the explanation from city management and performed no further work." In fact, our work in this area conformed to the requirements of AU 329.22 which requires that the auditor document "any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures". The explanation obtained from finance personnel was that "due to a decrease in overall general fund revenues in the current fiscal year, the City cut several recreation and sports programs offered to the community." We documented at workpaper 3-10 that this explanation was reasonable in light of current economic conditions and that, accordingly, no further testing needed to be performed. The variance was neither unexpected, nor was the explanation inconsistent with information known to the audit team concerning the economic environment in which local governments are operating. Corroboration of this known economic condition was clearly not warranted in this situation. It should be noted that the variance in question was a decline in salaries expense, rather than an increase in salaries expense. A material increase in compensation revealed by our analytical review procedures might have warranted substantiation due to the potential implied risks of fraud not present in a decline in salaries expense.

CONSIDERATION OF CONTRACTS, GRANT AGREEMENTS, LAWS AND REGULATIONS

We disagree with the SCO conclusion that our audit workpapers documentation did not consider compliance with laws and regulations that may have had a direct and material effect on the determination of

financial statement amounts. We provided the SCO office with our permanent files supporting:

- All Important Agreements, Contract and Debt Provisions, including all Revenue Bond Agreements, Lease Obligations, Concession and other Income Agreements, Pension Plan Information, Joint Powers Authorities, Management Agreements, Important ordinances and resolutions, Notes, Developer Agreements and other important copies of accounting and reporting requirements.
- Our audit documentation demonstrates at workpaper C-1 that our audit tests were designed to test investment Compliance in accordance with various sections of the California Government Code (Sections 53601 and 53646). These were identified as specific audit risk areas requiring documentation of compliance with the California Government Code.
- Our audit risk assessment also identified debt compliance as a risk area and specific audit tests were documented at workpaper C-6. Official statements in our permanent files were also used to document our conclusion on consideration of compliance with important agreements.
- Our audit documentation and audit program together with an agreed-upon audit procedures report addressed Articles XIII B of the State Constitution as an important law to test. Those audit procedures were documented at workpapers S-0, S-1, S-2, S-3, and 1-6.
- Extensive testing of laws and regulations pertaining to federal funding (workpapers SA 1-1.2 through SA LL-4) and redevelopment compliance (workpapers R-0 through S-3) were performed as a part of our audit of the City of Redevelopment Agency.

As stated above, there was extensive documentation in our audit workpapers that identified which laws and sections of the Government Code that we believed were important when designing our audit procedures. The fact that certain audit procedures were not signed off on the audit program until near the end of the audit was not indicative of when the audit work associated with the step was started, substantially performed, and resolved as to all pending items. The audit documentation in our planning section at workpaper 3-0 to 3-7 were dated in March, 2009 when the audit planning commenced. The audit process continued from March to December 2009 and audit documentation was prepared and reviewed throughout the audit process. The audit steps and documentation of the audit work were therefore completed before the audit report was issued. Therefore, we disagree with the SCO conclusion that consideration of the foregoing was not done during the planning process. Based upon the audit evidence in the working papers cited above, appropriate consideration was given to laws and regulations that were likely to have a direct and material impact on the determination of financial statement amounts.

SCO's Comments

Analytical Procedures

As stated in our finding, the firm did not document all relevant factors in establishing the materiality levels. We could not determine that the firm considered the public interest and sensitivity of government audits. The users of governmental entity financial statements are not shareholders but taxpayers whose needs differ from those of an an investor.

AU 312 .04, Audit Risk and Materiality in Conducting an Audit states, in part:

> . . . materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." That discussion recognizes that materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

The firm did not document the factors it considered in developing it analytical procedure expectations (comparing current and prior year revenue and expenditure accounts greater than $400,000 and the resulting variances in excess of 15% and $200,000). For example, there is no documentation in the working papers as to why those levels would identify misstatements, individually or in the aggregate, that could result in a material misstatement on the financial statements.

GAGAS 3.38 states:

> Auditors should document significant decisions affecting the audit objectives, scope, and methodology; findings; conclusions; and recommendations resulting from professional judgment.

The firm stated that it determined materiality for the entity on an opinion unit basis; which forces a lower level of materiality for governmental audits. However, the firm did not explain how it documented the additional materiality considerations applicable to governmental units. The firm's response indicated that there were no unusual issues of fraud risk that would warrant a change in planned materiality. Workpaper 3-5B, which was prepared by the city, contains no written evaluation of the city's responses by the firm. The firm's procedures state, "MHM carried forward questionnaire from PY and inquired with management as to any changes in responses or significant positions in management that changed, indirectly effecting the original responses. Management asserted no significant changes in both positions in management and responses listed." There was no evidence in workpaper 3-5B that the firm actually assessed whether there were unusual issues of fraud risk, political sensitivity, or legal or regulatory compliance as the firm stated in its response.

The firm states that it considered the qualitative aspects in assessing its planning materiality. In fact, it refers to workpaper 3-11 which quotes step 6 of the Practitioner's Publishing Company (PPC) instructions on the Materiality Worksheet for Planning Purposes. However, this quote from the PPC does not constitute documentation of the firm's consideration of the qualitative aspects of planning materiality. There was no evidence in the working papers or original work by the auditor documenting the actual qualitative aspects the firm considered, such as the potential effect of the noncompliance on the city's ability to raise resources in the future, whether the noncompliance involves collusion or concealment, etc.

The firm stated that it intentionally and deliberately excluded capital assets from its consideration of planning materiality because the large dollar balances might distort its consideration of planning materiality. However, capital assets are not reported in governmental funds. Capital assets are only reported in government-wide financial statements after GASB 34 conversion entries are posted. The firm used prior year asset accounts, which in most cases were higher than current year, to determine materiality. Although an acceptable audit practice, it increased the materiality level.

The firm's response stated that the standards and facts indicate that our suggestion that the firm relied on the same analytical procedures to conclude that the financial statements were fairly stated instead of performing other substantive tests was inaccurate. The firm citied AU 329.22 to support its response. However, AU 329.22 refers to documentation requirements for analytical procedures. Our finding states that analytical procedures may not be as effective or efficient as tests of details in providing the desired level of assurance for some assertions (AU 329.10).

We did not state that the firm relied solely on analytical procedures as claimed in the firm's response. Our finding states that the firm primarily relied on analytical procedures as substantive tests; and, as a result, did not obtain assurance on all of the relevant financial statement assertions.

AU section 318.51 states:

> Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. This reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control, including management override, and even effective internal controls generally reduce, but do not eliminate, the risk of material misstatement.

For example, for accounts receivable, we questioned why the firm had not verified the collectability of a $300,000 loan that was more than a year old. The promissory note that was provided to us with the firm's response shows that the principal balance and applicable interest was due on December 1, 2008. The loan was in default when the 2008-09 audit

report and financial statements were issued; however, because the firm relied primarily on analytical procedures, it did not identify that the loan was delinquent. In addition, we noted that the Chief Administrative Officer (CAO) did not sign the promissory note even though the note contained a signature line for the CAO signature.

The firm stated that for accounts receivable it vouched certain individually significant items at working paper D-1. The working paper shows that retail sales tax totaling $230,700 and a cash receipt from Los Angeles County totaling $257,815 were the only receivables verified via subsequent receipt. The balance sheet shows $7,126,028 in Due from Other Governments, which is considered to be a receivable. Of this amount, $5,229,204 is taxes receivable, which, according to working paper D-1 page 7, are property taxes to be included on the property tax roll for 2009-10. The firm explained that these amounts were recognized as a receivable in the specific fiscal years for which the taxes pertained, even though the enforceable legal claim (the levy) occurred in a subsequent period. Note 1F in the Notes to the Financial Statements indicates that the amounts in Due from Other Governments are collected and unremitted to the City as of June 30, 2009. However, the audit report did not disclose that the $5.2 million did not have the same liquidity as other items classified as due from other governments. This information should have been separately disclosed because these taxes would not be collected and therefore could not be used to meet current obligations. Also, the firm's deferred loans receivable working paper stated that the auditor vouched additions and deletions greater than $100,000 to support. However, there is no explanation as to why the auditor did not verify whether receivables that were more than one year old were still valid.

The firm stated that for the disclosure assertion, it utilized the firm's disclosure checklist. However, completing the disclosure checklist is not a substantive procedure that evaluates whether material amounts requiring separate disclosures have actually been separated in the financial statements. For example, the financial statements did not disclose that receivables had different liquidity characteristics as required by GASB 38¶13.

Assertions about presentation and disclosure deal with whether components of the financial statements are properly classified, described, and disclosed. In fulfilling the disclosure objective, the auditor tests to make certain that all balance sheet and income statement accounts and related information are correctly set forth in the financial statements and properly described in the body and footnotes of the statements. However, the auditor cannot determine that financial information is accurately and adequately disclosed unless substantive audit procedures were performed to verify the financial information.

For example, substantive tests of the payroll expenditures, such as balancing payroll expense to payroll registers, may have disclosed that advances to employees were classified as payroll expenditures, not as receivables from related parties. Substantive tests of account receivable,

such as a review of aged receivables, would have disclosed that a $300,000 loan receivable was not valid.

We did not state that the firm was required to test all assertions relative to an account balance or transaction class. Our finding states that the firm did not obtain assurance on all of the **relevant** financial statement assertions.

Cash and Investments

We did not suggest that the scope of an audit requires the investigation and disposition of every unreconciled difference identified in the city's books and records. Our finding states that the firm did not comply with audit standards which require documentation supporting that the accounting records agree to or reconcile with the audited financial statements (AU 339.10).There was no explanation in the working papers as to why the supporting documentation did not agree or reconcile with the audited financial statements. In addition, there was no evidence in the working papers that the auditor noticed that records did not reconcile to the financial statements.

Receivables

The firm responded that the transaction was made in fiscal year ended June 30, 2008, and that it reviewed the underlying documentation in that fiscal year. However, there was no evidence in the 2008-09 working papers of the prior year review or how that review established the existence, ownership, and validity of the note as of June 30, 2009.

The firm's response states that the $300,000 loan receivable asset was offset by an equal liability; therefore, there was no misstatement with regard to the fund balance. The firm's response does not address that both assets and liabilities were misstated. Additional documentation provided by the firm in its response disclosed that the $300,000 loan receivable with a due date of December 1, 2008, was in default as of June 30, 2009, and should not have been recorded as a receivable.

We did not suggest that the scope of an audit requires the investigation and disposition of every unreconciled difference identified in the city's books and records. Our finding stated that the firm did not comply with audit standards which require documentation to support that the accounting records agree to or reconcile with the audited financial statements (AU 339.10). There was no explanation in the working papers as to why the supporting documentation did not agree or reconcile with the audited financial statements.

Capital Assets

The firm's response does not address the fact that the capital asset addition was undervalued by $200,000. The firm states that working paper 3-7A documents that it reviewed the capital asset addition as part of its journal entry analysis. However, working paper 3-7A did not contain a reference to the firm's journal entry testing working papers. In

addition, the journal entry testing indicates that the firm tested for the assertions of reasonableness, completeness, and adequacy of review, as understood based on working papers STC-1 through 6. There is no evidence in the journal entry testing working papers that the firm obtained the deed of trust or verified existence and ownership of the building based on other evidence. The firm should have compared the recorded transaction (i.e., journal entry), with the appraisal or other documentation that supported the value of the asset. If this had been done, the auditor would have noted that the promissory note on the asset was different from the appraised value of the asset.

AU Section 326.28 states:

> Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial statement instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting principles, such as revenue recognition.

GAGAS 4.25 states that due to the audit objectives and public accountability of GAGAS audits, there may be additional considerations for financial audits completed in accordance with GAGAS, including fraud and illegal acts. The capital asset in question was purchased from the former mayor; therefore, the firm had an obligation to ensure that the asset was properly valued. We question why the firm determined that the promissory note provided was sufficient evidence of existence, ownership and valuation.

The firm stated that the audit program conclusion of no impairments detected was documented through tests of capital assets and inquiry of client personnel; however, as noted in our finding, there was no evidence of this in the working papers. As noted in Finding 4 – Deficiencies in documenting and evaluating subsequent events, there was a prominent and conspicuous impairment of capital assets, which was known to city management. The fact that the city did not disclose this impairment to the firm does not negate the firm's obligation to identify impairments through other audit procedures.

The firm relied on the review of the minutes when items known to them were not included in the minutes. Its review of the minutes from the period July 9, 2008 to December 15, 2009 listed only four items of audit significance. Three of the items regarded changes in the city council membership and the fourth item was the approval of an agreement for professional consulting services for the administration of the CDBG program. There was no indication that the city council had discussed and approved the amendment that extended the maturity of the taxable lease revenue bonds or the issuance of a promissory note for $4,600,000. There was no indication that the city council had approved budgets or minutes of prior meetings. The auditor did not question why these significant items were not discussed by the city council. The firm relied on the council minutes to disclose items of audit significance even

though they were aware that significant items were not addressed in the council meeting minutes.

The firm stated that it reviewed the city's journal entries to record additions and deletions to fixed assets to determine if the key internal controls were in place. However, this procedure would not identify assets that should have been capitalized but were not.

The firm stated that deletions did not involve the disposition of assets acquired with federal funds. However, there was no evidence in the working papers that the firm verified that equipment was not purchased with federal funds and not subject to federal disposition requirements.

Finally, the firm stated that the foregoing facts clearly demonstrate that controls over completeness of capital assets were very satisfactory. However, our finding was not that controls were unsatisfactory but rather that the firm did not adequately document the audit procedures it performed, or evidence obtained in testing capital assets.

Payroll

We did not state that the firm's auditors used only analytical tests of payroll. We stated that the firm primarily tested payroll using analytical procedures. The only payroll accounts that met the analytical review threshold of a change of $200,000 or 15% were in the General Fund. Only General Fund payroll accounts appear on the firm's analytical review of revenues and expenditures.

The firm stated that it is not uncommon for a City Manager's salary to be allocated to various funds of the local government. Therefore, the firm should have identified all salary paid to the City Manager and determined whether it warranted further investigation. In addition, because the City Manager was in a position to override internal controls, his salary and other payments should have been reviewed.

The firm's response did not explain why the risk of fraud was not affected by the Chief Administrative Officer's (CAO) incentive to improperly post transactions to keep the General Fund balance positive. The firm's response did not address if it was aware of the CAO's employment agreements or how these agreements may have affected procedures performed.

The firm stated that it reviewed the trial balances to look for employee advances. However, a review of the trial balances is not a substantive audit procedure. A review of the trial balances would not have identified unusual account activity or that payroll expenditures were not supported by payroll registers. The city did not post the advances as loans or receivables; therefore, review of the trial balances would not identify them. The city posted the advances as payroll expense in the Paid-In-Lieu-of-Vacation account.

The firm stated that disbursements tests did not disclose any disbursements to employees that were not properly documented or

recorded. However, the testing referred to was a test of controls, not a substantive test. A test of controls would only identify whether controls were operating effectively, not whether an expenditure was in compliance with laws and regulations. For example, the auditor verified that the "Invoice is approved for payment by individual knowledgeable of goods/services received – Dept. Head." The firm did not verify whether the expenditure was approved by someone knowledgeable of laws, regulations, and program requirements.

The firm's response does not explain why inquiry of management replaced a substantive audit procedure to identify bonuses. Relying on the city's past practices and statements by management is not a substantive test. Inquiry alone does not provide sufficient audit evidence to detect a material misstatement (AU 326.35). The auditor should perform other appropriate audit procedures to determine whether changes have occurred that may affect the reliability of such information.

The firm relied on analytical procedures and statements by management and did not perform additional substantive audit procedures to verify the validity of the statements. If the firm had performed substantive audit procedures, such as reviewing general ledger payroll account activity or employment agreements, it may have identified advances of public funds and bonuses to employees.

Consideration of Contracts, Grant Agreements, Laws and Regulations

The audit program for review of minutes, contracts, ordinances, and laws did not include any references to documents and resources the firm used to determine which laws and regulations may have a direct and material effect on the determination of financial statement amounts. In addition, the program contains no dates that indicate that the documents and resources were reviewed during the planning process. The firm is obligated to document its work to the extent that reviewers can obtain a clear understanding of the work performed, the audit evidence obtained and its source, and the conclusions reached. (GAGAS 4.19). In addition, AU section 339.10 states that the auditor should prepare audit documentation that enables the reviewer to understand the nature, **timing** and extent of auditing procedures performed.

Additional SCO Comments

We offer the following comments in response to the information and comments provided by the firm at the December 3, 2010 exit conference. The firm stated that to support its opinion on the city's financial statements it supplemented its analytical procedures with tests of transactions. We re-reviewed the test of transactions working papers and noted the following:

1. Test of transactions at the Disbursement Cycle – The firm tested 25 transactions, totaling $52,294, which amounted to .078% of total city expenditures ($67,740,175)

2. Test of transactions for the Community Development Block Grants (CDBG) – The firm tested 6 expenditures totaling $73,000, which amounted to .108% of total city expenditures.

Thus, the tests of transactions combined covered 0.185% of total city expenditures.

According to the firm, the test of transactions at the disbursement cycle served dual purposes – testing internal controls and substantive testing. Based on the procedures performed, the firm concluded that internal controls were in place and could be relied on. However, there is no indication on the test of transactions working paper (STC 2-B.2) to show that the tests were designed to serve dual purposes. In addition, there was no indication in the firm's working papers that it increased its sample as required by AU 350.44. Further, there is no indication that the transactions tested represented the various funds on the financial statements.

The test of transactions working paper stated that the purpose was:

> To determine if internal controls over cash disbursements are adequate in order to mitigate risk of fraud and if the expenditure was for a purpose or activity appropriate for charging to that fund and if planned audit procedures will have to be altered at FYE 6/30/09.

Although the purpose identified that the auditor would determine if the expenditure was appropriate to the fund to which it was charged, the working paper contained no evidence that this attribute was tested.

In addition, as the firm relied extensively on the city's internal controls to reduce its substantive tests, it should have increased the extent of its tests of controls as required by AU318.

AU section 318.21 states, in part:

> Valid conclusions may ordinarily be drawn using sampling approaches. However, if the sample size is too small, the sampling approach or the method of selection is not appropriate to achieve the specific audit objective, or exceptions are not appropriately followed up, there will be an unacceptable risk that the auditor's conclusion based on a sample may be different from the conclusion reached if the entire population was subjected to the same audit procedure. . .

AU 318.47 states, in part:

> To reduce the extent of substantive procedures in an audit, the tests of controls performed by the auditor need to be sufficient to determine the operating effectiveness of the controls at the relevant assertion level and the level of planned reliance.

AU 318.48 states, in part:

> The auditor should increase the extent of test of controls the more the auditor relies on the operating effectiveness of controls in the assessment of risk. . .

There was no indication in the working papers that the firm increased the extent of its tests of controls.

Finally, since the firm stated its test of transactions was meant to serve a dual purpose, the scope of the testing should have covered the entire fiscal year – July 1, 2008 through June 30, 2009, as required by AU 311.34, Appendix A2. However, its test of transactions only covered part of the fiscal year—July 1, 2008 through March 23, 2009.

AU 311.34, Appendix A2, states, in part:

> The auditor may consider the following matters when establishing the scope of the audit engagement:
>
> - The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect of the information obtained during such reviews.

CAPITAL ASSETS

The firm stated that it relied on management's assertion in the management representation letter to determine that capital assets were not impaired. AU 333.07 states, in part:

> The representation letter ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry. . .

Examples of such representations are provided in the PPC guide. For example, the representation should include the following assertions:

> Capital assets have been evaluated for impairment as a result of significant and unexpected decline in service utility. Impairment loss and insurance recoveries have been properly recorded.

We reviewed the management representation letter included in working papers and found that it did not contain any assertion regarding impairment of capital assets. In addition, we noted that the management representation letter contained assertions that were not relevant to the city such as,

- We have monitored subrecipients to determine that they have expended pass-through assistance in accordance with applicable laws and regulations and have met the requirements of OMB A-133. (item n)

- We have taken appropriate action, including issuing management decisions, on a timely basis after receipt of subrecipients' auditor's reports that identified noncompliance with laws , regulations, or the provisions of contracts or grant agreements to ensure that subrecipients have taken the appropriate and timely corrective action on findings. (item o)

- We have considered the results of subrecipient audits and have made any necessary adjustments to our books and records. (item p)

The firm did not review the management representation letter to determine that it contained the applicable and appropriate assertions. The firm's comments do not support that it adequately tested for capital assets impairments.

Furthermore, the PPC Guide's Control Activities Form for Capital Assets and Expenditures, lists various controls for assessing assets for impairments. The firm's description and tests of controls over capital assets do not include any discussion or tests of controls regarding impairments.

PAYROLL

The firm stated that it supplemented its analytical procedures with tests of controls over payroll. However, its tests of key controls, as documented at STC4-C, consisted of:

1. Verification that one payroll register contained management's initials as evidence of review.

2. Notation that two items on the payroll change report were supported by Personnel Action Forms.

3. Verification that employees who have password access to the payroll master file change list do not process payroll.

The test of transactions in the Disbursement Cycle did not include any payroll transactions. The payroll testing for CDBG consisted of testing the salary allocations of nine employees that were charged to the CDBG program.

In addition to its noncompliance with audit standards, the firm did not comply with section 5097 of the California Business and Professions Code as follows:

> (a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.
>
> (b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.
>
> (c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit

> that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

Our finding and recommendation remain unchanged.

FINDING 2— Deficiencies in the firm's consideration of the risk of fraud in a financial statement audit

Our review of the firm's consideration of fraud risk disclosed that the firm assessed risk of fraud as low, concluded that it could rely on the city's internal controls, and reduced its substantive testing to consist primarily of analytical procedures.

However, our review disclosed that the firm did not consider the following risk factors:

- The City of Bell became a charter city in 2005.
  - The charter allowed the members of the City Council to receive compensation for their services; however, their compensation was not to exceed the compensation that city council members of general law cities of similar population would receive under state law. There was no evidence that the firm considered or discussed whether to audit the city council members' compensation or the impact that compensation would have on the councils' decision making.
  - The charter required the Chief Administrative Officer (CAO) to furnish a corporate surety bond conditioned upon the faithful performance of duties in such form and in such amount as may be determined by the city council. There was no evidence that the firm considered determining whether the CAO had furnished the required surety bond.
  - The charter authorized the city to levy and impose taxes, assessments, and fees for municipal purposes to the full extent permitted by the California Constitution. There was no evidence that the firm considered whether it should determine whether the increases in taxes, assessments, or fees were compliant with the Constitution or if non-compliance would have a direct and material effect on the city's financial statements.
- The firm's Entity and Activity Level Control Worksheet documented that:
  - The CAO approves and executes city transactions and informs the city council of the city's operations.
  - The CAO appoints the city's department heads to carry out the city's operations, and authorizes the levels of authority and responsibility pertaining to each department.
- Employment agreements for the city's executive management staff indicated that their compensation was based on financial results. Consequently, the firm was unaware of the CAO's incentive to redirect expenditures from the General Fund in order to ensure a

positive balance in the General Fund (see Finding 1—Audit documentation and evidence deficiencies).

AU section 110.02 states, in part:

> The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. . .

AU section 316.01 states, in part:

> . . .This section establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS).

AU section 316.31 states, in part:

> Because fraud is usually concealed, material misstatements due to fraud are difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

AU section 316.42 states, in part:

> Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk…apart from any conclusions regarding the existence of more specifically identifiable risks.

AU section 316.57 states:

> As noted in paragraph .08, management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively. By its nature, management override of controls can occur in unpredictable ways. Accordingly, in addition to overall responses (paragraph .50) and responses that address specifically identified risks of material misstatement due to fraud (paragraphs .51 through .56), the procedures described in paragraphs .58 through .67 should be performed to further address the risk of management override of controls.

AU section 316.85 provides examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting. These include, in part:

> A.2 - Incentives/Pressures

c. Information available indicates that management's or those charged with governance's personal financial situation is threatened by the entity's financial performance arising from the following:
   - Significant financial interests in the entity
   - Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow

A.2 - Opportunities

b. There is ineffective monitoring of management as a result of the following:
   - Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls
   - Ineffective oversight over the financial reporting process and internal control by those charged with governance

If all risk factors are not considered, the risk assessment may not be valid and will impact the nature, timing, and extent of audit tests.

Recommendation

The firm should consider all risk factors when gaining an understanding of the entity being audited, including:

- Compliance with laws and agreements,
- Management's ability to override controls, and
- Employment agreements that contain incentives based on financial performance.

Firm's Response

We disagree with the SCO conclusion that there were deficiencies in the Firm's consideration of the risk of fraud in a financial statement audit as required by AU Section 316 of the AICPA Professional Standards. Specifically, our audit documentation did consider Antifraud Programs and Controls and it did not do so, as the SCO suggests, in some sort of "Pro-forma manner". Workpapers 3-5B through 3-5C documents that during the audit planning, extensive documentation was obtained from the DAS to document Entity and Activity Level Controls (Attachment #2). From all documentation received and from our observation of the environment, there was no perceived heightened risk of fraud. All documents obtained indicated that the City of Bell had programs and controls in place to prevent, deter and detect fraud. We were provided a copy of the City's Fraud Prevention Policy, dated July 1, 2008 (Attachment No. 1) which indicated that it was approved by the City Council. This document was drafted by the Finance Department (Principally DAS) and was approved by City Council. See attached Fraud Prevention Policy, dated July 1, 2008 (Attachment #1). This workpaper was previously provided to the SCO with our permanent file of documents at workpaper III-2,6. This document was reviewed by the Engagement Manager and Engagement Shareholder during the 2009 audit.

We disagree with the SCO conclusion that we did not comply with professional standards pertaining to which audit personnel should be involved in the documented discussions regarding the risk of material misstatement due to fraud. AICPA Professional Standards AU 316.17 states that "the discussion ordinarily should include the key members of the audit team". Our workpapers document that the Shareholder, Engagement Manager and Senior Field Auditor were the key members of the audit team and present during this discussion. Additionally, all work of associates who participated in the audit was reviewed by one or more key members of the audit team. Our workpapers document (at workpaper 3-5B) that there was no change in the entity-wide fraud controls from that of the previous year based upon evidence that is at workpaper 3-5B. Accordingly, the documentation of our engagement team discussion of fraud risk and misstatement risk that occurred during the planning phase of the 2009 audit took into account our prior experience and understanding of these controls and their impact on the audit. Had there been a change in controls that became known to the team member subsequent to that meeting, the team member identifying that change in controls would have initiated contact with other team members so that our engagement team discussion and conclusions could have been amended. The SCO conclusion is correct that the Auditors assessed the fraud risk as low. Our reliance on internal controls was based upon tests of key controls. These key controls were documented at the following workpaper locations:

- Revenues STC-1 series of workpapers
- Payroll STC-4 series of workpapers
- Bank Reconciliations STC-5 series of workpapers
- Capital Assets STC-6 series of workpapers
- Expenditures/Purchases – STC-2 series of workpapers
- Investment – STC-3 series of workpapers

The draft SCO report suggested that the documentation of our engagement team discussion contained only a preformed list of matters to discuss, with no added matters that were specifically addressed during the actual engagement team discussion for the City of Bell. This is incorrect. Our documentation of the engagement team discussion ("brainstorming session") at workpaper 3-6, specifically identified the following explicit matters that were not a part of the "performed" items in the form used by the team to document the engagement team discussion, but were in fact added to the form as explicit documentation of actual matters discussed during this meeting:

1. Revenue Recognition.
2. Classification of Expenditures (In The Right Funds) – TOT (Test of Transactions)
3. Transfer to/from other Funds – Transfer of Restricted Funds to Non-Restricted Funds.

We further documented on the same form the actual procedures that were later performed to address the specific matters emphasized during the engagement team discussion.

Revenue Recognition.
MHM Tested Revenues/Receivable In Determining If The City Is Following A Proper And Adequate Revenue Recognition Policy As Per What Is Disclosed In Their Financial Statements. See D-Section.

Classification Of Expenditures (In The Right Funds) – TOT (Test of Transactions)
MHM Selected 25 Random Expenditures Incurring Between The Period Of 7/1/09 And 3/23/09. MHM Tested These Expenditures For Proper Fund Classification, Reasonableness And Other Criteria As Defined By The Testwork. See STC2-B.1.

Transfer To/From Other Funds – Transfer Of Restricted Funds To Non-Restricted Funds.
MHM Tested Transfers To/From Restricted Funds. MHM Tested The Transfers Out Of Restricted Funds. See I-Section.

As documented in the Summary of Significant Accounting policies, the City of Bell was a Charter City commencing January, 2006. Our testing of the City Charter was principally directed at City Treasurer and Finance duties that are referred to in Sections 705 and 706 of the Charter. We observed no other significant items in the Charter requiring attention. We concur that our documentation and rationale of significant charter considerations should have been included in our electronic files or permanent file. We also believed that the City of Bell Procedures Manual (in our Permanent File III-2, 4) was an important consideration of the risk of fraud in a financial statement audit. This document was utilized in our 2009 audit as a supplement to our documentation of fraud risks and internal controls and in the application of our key controls testing as we examined documentation during our testing of cash disbursements.

City Council compensation and the surety bond referred to in the City Charter are not matters that would have a direct and material effect on the determination of financial statement amounts. Further, we disagree with the SCO conclusion that had our documentation included an analysis of significant Charter provisions, it would not have provided any guidance on whether tax increases were compliant with laws. The SCO in another report to the LA County Auditor-Controller as part of its earlier performance audit stated that on July 27, 2007, the City Council passed resolution 2007-42 that improperly increased the rate of Retirement Tax. The Charter of the City of Bell is very general in nature and did not provide the specificity to speak to the technical issues of legal compliance that were addressed in the State Controller's more expansive performance audit that addressed the legal and governance issues that were beyond the scope of a financial statement audit for local government entities.

The SCO report suggested that the CAO was the primary individual involved in executing internal controls of the City in 2009. However, as documented by our tests of key controls, in 2009, there were a number of personnel (not just the CAO) involved in the execution of key controls and transactional controls were sufficient to support our assessment of control risk for purposes of evaluating the risk of material misstatement. Furthermore, as documented in the City's internal controls, there was no evidence or indication that there was a heightened risk of management override.

> As a further matter in our fraud risk assessment, our Firm communicated in writing with the Bell City Council twice during the audit on April 8, 2009 (Attachment #7) and again on December 18, 2009 (Attachment #8). The City Council was allowed direct access to the Engagement Shareholder via phone or email on matters relating to any matters of employee fraud or any other instances of improper practices of the City of Bell (Workpapers I-5 and I-5, 2). We documented (on 1-5.2) that in response to our inquiries, no councilmembers identified known or suspected concerns regarding fraud.

SCO's Comment

The firm stated in its response that its documentation and rationale of significant charter considerations was not included in its electronic files or permanent files. As a result, we were unable to determine whether the firm considered the fraud risk factors related to the charter provisions. With regard to the city's procedures manual, the firm did not document its consideration of the city's procedures manual and impact these procedures had on the testing of the key transactions cycles, such as cash receipts, disbursements and payroll, etc.

The firm did not comply with audit standards by documenting its understanding of the entity and its environment. According to AU 314.21 a and b, the auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

a. Industry, regulatory and other external factors

b. Nature of the entity

The aspects include the legal and political environment, environmental requirements, and the general economic conditions that affect the entity being audited. (AU 314.24).

In addition to its noncompliance with audit standards, the firm did not comply with section 5097 of the California Business and Professions Code as follows:

> (a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.
>
> (b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.
>
> (c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant

> conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

The firm responded that the city council compensation and the requirement for a surety bond are not matters that would have a direct and material effect on the determination of financial statement amounts. However, opining on the financial statements is not the only objective of a single audit. The auditor also has to express an opinion on compliance with laws and federal regulations.

The firm stated in its response that its tests of key controls identified that a number of personnel, not just the CAO, were involved in the execution of key controls, and that there was no evidence or indication that there was a heightened risk of management override. However, the firm did not document in its working papers that it performed specific procedures to address the risk of management override of controls in its assessment of fraud risk, as required by AU section 316.57.

Based on additional information provided by the firm regarding the firm's engagement team discussion, this deficiency has been removed and our finding and recommendation have been revised.

FINDING 3— Deficiencies in evaluating and documenting going concern

In evaluating going concern, the firm stated that it reviewed governing council minutes, inquired of management about subsequent events, and performed final analytical review procedures. The firm concluded all appropriate issues raised by those procedures were documented as to disposition, so no going concern issues were identified.

However, the notes to the basic financial statements (Note 17– Subsequent Events) disclosed that the city extended the maturity date of the $35 million Taxable Lease Revenue Bonds by one year (from November 1, 2009, to November 1, 2010).

The firm's working papers do not contain evidence that it noted that the city had extended the maturity date of the bonds or evaluated the reason for the extension. Also, there was no evidence that the firm considered whether the city was facing economic uncertainty which prevented the city from paying the bonds on the original due date.

Based on the working papers, we cannot determine whether the firm evaluated the city's ability to meet its obligations for normal operations, as well as the debt service payments on its $150 million in long-term liabilities.

Our review of the financial statements disclosed:

- The city's General Fund expenditures exceeded revenues by $1,754,266.

- Three funds had negative fund balances totaling $8.886 million as follows:

Fund Name	Deficit Amount
Retirement Special Reserve Fund	$ 3,049,483
Community Redevelopment Agency – Debt Service Fund	3,650,536
Public Financing Authority – Debt Service Fund	2,186,184
Total	$ 8,886,203

According to the working papers, the auditor reviewed fund balances and concluded "Based on review of internal controls, there are no areas where we noted fund equities as being significant deficiencies." The auditor did not document or explain why the deficit balances totaling $8.886 million were not considered significant.

The firm's audit program contained a Practical Considerations item that stated:

> A deficit in a debt service fund usually indicates poor financial management and may indicate overall financial distress. Operating losses and increasing deficits in the general fund may also indicate financial distress.

Although the audit program used by the firm contained this advice, there is no evidence in the working papers that the auditor considered this information in reaching his/her conclusion on fund balances. In addition, the auditor did not document the reason for the deficit balances, management's plans for dealing with the financial conditions that caused the deficit, or the adverse effect of the deficit balances.

AU section 341.02, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, states, in part:

> The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report. . .

AU section 339.10, Audit Documentation, states, in part:

> The auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand:
>
> *a.* The nature, timing, and extent of auditing procedures performed to comply with SASs and applicable legal and regulatory requirements;
>
> *b.* The results of the audit procedures performed and the audit evidence obtained;

c. The conclusions reached on significant matters; and

d. That the accounting records agree or reconcile with the audited financial statements or other audited information.

When going concern is not properly evaluated and the risk is not disclosed, users of the financial statements and the audit reports (i.e., the public, legislators, and government officials) cannot make knowledgeable decisions regarding the entity's financial position, its ability to meet its current obligations, and the performance of the entity's management and governing board.

Recommendation

The firm should comply with auditing standards as follows:

- Document in the working papers, its basis in determining that the entity can meet its current obligations and continue operations for a reasonable period of time.
- Utilize the Practical Considerations contained in its audit programs.

Firm's Response

We disagree with the SCO conclusion that we did not properly evaluate and document the City of Bell's ability to continue as a going concern for a reasonable period of time, as required under Generally Accepted Auditing Standards (GAAS).

With respect to the auditor's responsibility regarding going concern issues, AU 341.02 states:

> The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's' ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.

As a part of subsequent events review, we obtained documentation form the City's Finance Department supporting the First Amendment to the $35,000,000 Bell Public Financing Authority Taxable Leased Revenue Bonds, Series 2007 Financial Facility Agreement (Attachment #5). This documentation was obtained as a part of our subsequent events review and referred to in the audit program at workpaper 4-5. Our understanding was that under Section 2.4(a) of this Financial Facility Agreement (at workpaper Perm File II-3.5), the City had the option to extend the maturity date to November 1, 2010. This option was entirely within the control of the City. We understood that the reason for this extension was to ready the property for lease to BNSF Railway Company with which the Bell Public Financing Authority already had lease agreements in place on adjacent property (Permanent File II-4 documents, an existing lease with BNSF) or embark in new negotiations with a prospective lessee or buyer. The due date of this note, when considered in the 6-30-2009 audit, was 16 months beyond the fiscal year end. AU341.02 limits the auditor's responsibility for going concern issues to a reasonable period of time, not to exceed 12 months from the balance sheet date. The City did in fact continue as a going concern for 12 months following the June 30, 2009 audit period, notwithstanding the lease extension the SCO discusses. Moreover, the

SCO indicated that it cannot determine based upon out audit workpapers whether the City could meet its obligations and debt service payments. Our audit workpapers for long-term debt included third party confirmation of all significant debt as of 6-30-2009. Those audit workpapers at K-0 to K-7,4 documented that all debt payments were current, none were in default. We also inquired in our 3rd party verification of knowledge of any violations of bond covenants. There were no exceptions. Also, based upon the audit team key members' knowledge from prior year audit engagements, there had been no violations or non-payment on debt issues in prior years. Further, other than the issue discussed above on the $35,000,000, Series 2007 Financial Facility Agreement, there was no evidence at 6-30-09 that the City or its component units could not meet their obligations as they became due in the next 12 months (the reasonable time frame). That fact was documented in our audit program sign-off step 10(a) in workpaper 4-1.

The following are specific responses to the SCO comments on the financial statements:

- The General Fund expenditures exceeded revenues by $1,754,266. Our firm considered this in our final review of the results by the Shareholder, Quality Control Reviewer, Engagement Manager and Engagement Senior during their respective reviews of the financial statements of the City documented at 1-1(d) to 1-3(b) and 4-11 and on the Report Control Sheet Copies provided to the SCO upon commencement of its review. The General Fund of the City had positive fund equity of $15,686,907. This issue did not present a risk that the City could not continue as a going concern for the one year reasonable period.

- The Retirement Special Revenue fund had a deficit of $3,049,483. Our audit team considered this in our documented review of the audited financial statements (at workpapers 1-1(d) to 1-3(b). Based upon the fact that the City's General Fund had positive general fund balance at June 30, 2009 of $15,686,907, this issue did not present a risk that the City could not continue as a going concern for the one year reasonable period.

- The Community Redevelopment Agency in the CAFR had a deficit at June 30, 2009 of $3,650,536. The reason for this deficit was that the Government Finance Officers Association (GFOA) and Generally Accepted Accounting Principles (GAAP) require that, for CAFR presentation purposes, long-term advances be reflected as a fund liability (rather than proceeds of long-term debt) (See GASB Codification Section 2600.120). The long-term advances of $6,127,286 created the deficit. This does not create a going concern issue in that the deficit is created by a long-term liability to a related party with no impact on cash flow with respect to the time frame relevant for evaluation for going concern purposes under relevant audit and accounting requirements. It should be noted that the separate component financial statements issued for the RDA properly reported a positive fund balance at June 30, 2009 in the Debt Service Fund of $2,476,750, as required by GAAP applicable to separately issued component unit financial statements.

- The Public Financing Authority Debt Service Fund had a deficit at June 30, 2009 of $2,186,184. Based upon the fact that the General Fund had positive fund equity of $15,686,907 at June 30, 2009, this issue did not present a risk that the City could not continue as a going concern during the one year reasonable period.

All the foregoing was considered as set forth in the practical considerations of our audit program at workpaper 4-1. In summary and in our professional judgment and experience as independent auditors of municipalities in California, we concluded and documented the conclusion that there was not substantial doubt concerning the ability of the City to continue as a "going concern" for 12 months after the balance sheet date. Accordingly, no additional language was required to be included in the auditor's report with respect to this issue. Further, we believe that the disclosures regarding the subsequent event in Note 17 together with the disclosure in Note 7 of the CAFR properly and completely disclosed the terms and due dates of the 2007 Taxable Lease Revenue Bonds in the principal amount of $35,000,000. These dates fell outside of the window that would raise a going concern uncertainly. Further, we believe that the disclosures provided in the financial statements provided sufficient transparency so as to not mislead the users of the financial statements with regard to these issues. It should be noted that GASB Statement No. 56 makes it clear that the financial statement preparer (i.e., the City)—not the auditor—is primarily responsible for evaluating whether there is substantial doubt about the City's ability to continue as a going concern. This is stated clearly in paragraph 16 of that standard. It is important to note that GASB No. 56 establishes accounting and financial reporting standards, not auditing standards which are established by SAS No. 59. Furthermore, GASB No. 56 extends the consideration of going concern issues beyond the 12-month period established by SAS No. 59. This indicates that City management has a responsibility to report going concern issues that extend beyond those responsibilities placed on the auditor. In addition, GASB 56 paragraph 18 discusses that the effect of the governmental environment should be considered when evaluating indicators. Some conditions or situations identified in the indicators in GASB 56 paragraph 17 should be assessed differently. For example, recurring operating losses are commonplace for some business-type activities such as transit operations or governmental healthcare organizations. Governments may choose to subsidize these operations for political reasons. Thus, governments may have funds with deficit fund balances which will be "remedied" by transfers from the general fund.

We also note the SCO referenced on page 15 of the draft report that "Practical Considerations" in the audit program stated that "a deficit in a debt service fund usually indicates poor financial management and may indicate overall financial distress." However, practical considerations contained in the audit programs are intended to provide additional information to the audit team as a general reminder. They are non-authoritative, and do not apply to all clients and situations. An affirmative response in the audit working papers it not required for each practical consideration.

SCO's Comment

GASB 56 states that financial statement preparers have a responsibility to evaluate whether there is substantial doubt about a government's ability to continue as a going concern for 12 months beyond the financial statement date. This statement does not negate the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern. AU 341.02 makes it clear that the auditor also has a responsibility to evaluate the entity's ability to continue as a going concern. AU 341.02 states, in part:

> The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited (hereinafter referred to *as a reasonable period of time*). The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited. . .

Our finding does not state that we could not determine, based on the working papers, whether the city could meet its obligations and debt service payments. Our finding states that based on the working papers, we cannot determine whether the firm evaluated the city's ability to meet its obligations for normal operations as well as the debt service payments on its $150 million in long-term debt. The working papers do not indicate the firm investigated the reason the city extended the maturity date of the bonds to November 1, 2011. We question whether the firm adequately evaluated the city's ability to continue as a going concern, not whether the city has the ability to continue as a going concern.

The firm did not specifically document in its working papers its consideration of the city's ability to continue as a going concern. Even if the firm determined there was no going concern risk, the consideration should have been documented in the working papers.

The firm's response that the city's General Fund had a positive fund equity of $15,686,907 is misleading. The General Fund had an unreserved fund balance of only $10,987,770. The city had a reserved fund balance of $4,699,137 which was restricted and could not be used for general operating purposes.

The deficit fund balances totaled $8,886,203, which left only $2,101,567 of the $10,987,770 fund balance for general operating expenses and economic uncertainties that might arise. The General Fund expenditures exceeded revenues by $1.8 million in fiscal year 2008-09.

The firm's response that it believes that the disclosures regarding the subsequent event in Note 17 together with the disclosure in Note 7 of the CAFR properly and completely disclosed the terms and due dates of the

2007 Taxable Lease Revenue Bonds in the principal amount of $35,000,000, does not explain why an evaluation of going concern was not documented in the working papers.

The firm's response that the due dates of the bond debt payments fell outside of the window that would raise a going concern uncertainty does not address the fact that the subsequent event, the city extended the due date of bonds, did occur within the 12 month evaluation period , October 7, 2009.

The firm's response does not state why documentation regarding its consideration of going concern was not included in the working papers.

In addition, the firm stated that practical considerations contained in the audit programs do not apply to all clients and situations. However, because there was a deficit in the debt service fund, the audit team should have documented its consideration of the effect of the deficit on the city's ability to continue as a going concern.

In addition to its noncompliance with audit standards, the firm did not comply with section 5097 of the California Business and Professions Code as follows:

(a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.

(b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.

(c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

Our finding and recommendation remain unchanged.

FINDING 4—Deficiencies in documenting and evaluating subsequent events

The firm's audit program for subsequent events indicated that the firm did not identify any substantial contingent liabilities or commitments, or significant changes to the financial statements. However, the notes to the basic financial statements (Note 17–Subsequent Events) disclosed that on October 7, 2009, the city extended the maturity date of the $35 million Taxable Lease Revenue Bonds by one year (from November 1, 2009, to November 1, 2010).

We obtained additional information related to the taxable lease revenue bonds from an article, dated February 3, 2009, in the California Planning and Development Report. The article reported that, in the summer of 2008, a Los Angeles County Superior Court judge invalidated a 30-year option to lease between the City of Bell and Burlington Northern Santa Fe Railway (BNSF) because the city had not performed an environmental review prior to signing the option to lease. The judge also blocked a 45-year extension of an existing lease that permitted BNSF to continue using 14 acres of city-owned property. In addition, the article reported that the city was planning to use the BNSF lease payments to make the debt service payment on the $35 million lease revenue bonds and may extend the maturity date on the lease revenue bonds to November 1, 2010.

The firm did not document in the working papers whether city management had advised them of this event, and in its review of the governing council minutes, the firm did not note whether this extension was discussed and approved by the governing council. In addition, the working papers did not indicate whether the firm considered the impact of this event on its audit opinion (see Finding 3—Deficiencies in evaluating and documenting going concern).

AU 339.10, Audit Documentation, states, in part:

> The auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand:
>
> *a.* The nature, timing, and extent of auditing procedures performed to comply with SASs and applicable legal and regulatory requirements;
>
> *b.* The results of the audit procedures performed and the audit evidence obtained;
>
> *c.* The conclusions reached on significant matters; and
>
> *d.* That the accounting records agree or reconcile with the audited financial statements or other audited information.

AU 560.02 states,

> Two types of subsequent events require consideration by management and **evaluation [emphasis added]** by the independent auditor.

AU 560.11 states:

> Certain specific procedures are applied to transactions occurring after the balance-sheet date such as *(a)* the examination of data to assure that proper cutoffs have been made and *(b)* the examination of data which provide information to aid the auditor in his evaluation of the assets and liabilities as of the balance-sheet date.

AU 560.12 states, in part:

> In addition, the independent auditor should perform other auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to the fair presentation of the financial statements in conformity with generally accepted accounting principles. These procedures should be performed at or near the date of the auditor's report. The auditor generally should:
>
> *f.* Make such additional inquiries or perform such procedures as he considers necessary and appropriate to dispose of questions that that arise in carrying out the foregoing procedures, inquiries and discussions.

Recommendation

The firm should comply with audit standards and document its evaluation of subsequent events in the working papers.

Firm's Response

> We disagree with the SCO conclusion that there were deficiencies in our evaluation of subsequent events. The documentation of the subsequent events reviewed by the Senior Field Auditor (a key audit team member) on workpaper 4-5 clearly demonstrates the audit program steps and inquiries that were undertaken. Those steps referred to emails and attachments (which are attached to this response as Attachments 4, 5, and 6). This documentation includes all of the supporting signed amendments for the extension of the $35 million Taxable Lease Revenue Bonds.
>
> We believe that the auditing standards of care for subsequent events were fully met. Searching the California Planning and Development Report would not be a generally accepted practice in a financial audit of a city. We were unaware of the article referred to by the SCO concerning the lease evaluation. As discussed above, the court's order was not disclosed in City minutes, in the City's' written representations or by the City Attorney. As previously discussed and in the Attachment 5 referred to on workpaper 4-5, our audit team was advised of the exercise of the available extension option on the $35 million Taxable Lease Revenue Bonds. We believe that Notes 7 and 17 accurately disclose the documentation provided to our Firm pertaining to the $35 million Taxable Lease Revenue Bonds.
>
> We also disagree with the SCO conclusion that the subsequent event procedures were not at or near the end of the date of the Auditor's report. Our Auditor's report was dated December 18, 2009 and our

> subsequent event procedures were all performed within four days of that date. Five copies (and a master) of the report were released to the client on December 22, 2009.
>
> We concur that the emails referred to in the audit program sign-off should have been scanned into the electronic files; however, we believe this to be a minor documentation issue as the documents were referred to in the electronic workpaper 4-5 and can easily be validated by another experienced auditor.

SCO's Comment

The working papers do not indicate that the auditor determined the cause for the extension of the debt payment. Our simple internet search of the city's name disclosed the article that we referred to in our finding.

In addition to its noncompliance with audit standards, the firm did not comply with section 5097 of the California Business and Professions Code as follows,

> (a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.
>
> (b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.
>
> (c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

The firm's Item 3B in the working papers states that it inquired of management regarding whether any significant changes in capital stock, long-term debt, or working capital had occurred since the balance sheet date. The auditor noted that he/she inquired of management via e-mail on December 18, 2009 and "None NOTED". The $35 million Taxable Lease Revenue Bonds is not mentioned in the subsequent event working papers. In addition, none of the additional e-mails or attachments provided by the firm in its response to the draft report were included in the working papers, and the working papers did not include a reference (working paper reference number) to the e-mails or attachments.

In addition, the firm states that Notes 7 and 17 accurately disclose the documentation provided to it pertaining to the $35 million Taxable Lease Revenue Bonds. However, the working papers do not support the information disclosed in Note 17 to the financial statements.

The deficiency regarding the performance of subsequent event procedures after the date of the auditor's report has been removed based on additional information provided at the December 3 exit conference.

Our finding and recommendation have been revised.

FINDING 5— Deficiencies in identifying litigation, claims, and assessments

Our review disclosed the following deficiencies in the firm's identification of litigation, claims and assessments:

- The firm obtained a legal representation letter from the city's attorney, dated October 8, 2009, two months prior to the audit report date, December 18, 2009. The working papers contained a document that indicated that the firm followed up with the attorney by email on "11/XX/09" and that there had been no material change in litigation. However, a copy of the email was not documented, and without a date, we could not determine if the follow up occurred close to the expected date of the auditor's report. The firm should have obtained an updated response from the attorney to identify any litigation, claims or assessments that may have occurred between the date of the attorney's letter and the date that the independent auditor's report was issued. The attorney did not identify any pending or threatened litigation or unasserted claims and assessments that required disclosure in the audit report but circumstances could have changed during the two month period.

- Our review of the city's general ledger identified several payments totaling more than $427,000 to another law firm. There was no evidence in the working papers justifying why a letter of audit inquiry was not sent to this firm.

  As part of identifying litigation, claims, or assessments, the firm should have obtained from the city a description and evaluation of litigation, including matters referred to legal counsel. In addition, the firm should have examined city documents concerning litigation, claims, and assessments, including correspondence and invoices from lawyers. There is no evidence in the working papers that the firm performed these procedures.

  If the firm had performed these procedures, it should have identified the other law firm, and sent a letter of audit inquiry to them.

AU 337.05 section states, in part:

> . . .The independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

> *a.* Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
>
> *b.* Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel, and obtain assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by Statement of Financial Accounting Standards No. 5.
>
> *c.* Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers. . . .

AU section 337.08 states, in part:

> A letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments. . . .

AU section 9337.05 states:

> *Interpretation* - Section 560.10 through .12 indicates that the auditor is concerned with events, which may require adjustments to, or disclosure in, the financial statements, occurring through the date of his or her report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the date of the auditor's report as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the auditor's report will in most instances obviate the need for an updated response from the lawyer.

GAGAS 4.19 states, in part:

> Under AICPA standards and GAGAS, auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand
>
> a. The nature, timing, and extent of auditing procedures performed to comply with GAGAS and other applicable standards and requirements;
>
> b. The results of the audit procedures performed and the audit evidence obtained. . . .

If the effective date of the legal representation letter is not close to the date of the auditor's report, any litigation, claims or assessments that may have occurred between the date of the attorney's letter and the date that the independent auditor's report was issued may not be identified, and required adjustments or disclosures may not be reflected in the financial statements or notes. If all required procedures related to litigation, claims, and assessments are not performed, loss contingencies may not be properly accounted for or reported.

Recommendation

The firm should:

- Ensure that the effective date of legal representation letters is close to the date of the auditor's report. If a significant period of time occurs between the date of the legal representation letter and the date of the auditor's report, an updated response should be obtained.

- Perform audit procedures related to litigation, claims and assessments in accordance with AU section 337 requirements.

- Document all responses to representation letters, and follow up on inquiries, in the working papers.

Firm's Response

We disagree with the SCO conclusion that there are any significant short-comings in our assessment of litigation, claims and assessments. Specifically, the draft SCO report suggested that since we failed to include in our workpapers a copy of the emails that we received from the law firm with respect to the time frame through the date of our audit period, we did not conform to auditing standards. However, auditing standards do not require that such communication be performed via email or that if they were performed via email, that a copy of the email be provided in the workpapers. Our documentation on workpaper 4-3A substantially met the requirements of the standard except that the documentation at that workpaper showed 11/XX/09 as the date of our contact with the City Attorney, rather than the actual date of the emailed communication. The original notation of 11/XX/09 was a placeholder for our documentation of the final response from the attorney. Not changing the placeholder was a minor oversight with respect to the documentation of this issue. Further, on workpaper 4-3A and in the response of Edward Lee of Best, Best and Krieger, we were advised that his Firm was not aware of any pending or threatened litigation or unasserted claims that were probably of assertion. Mr. Lee and Best, Best and Krieger were the legal counsel for the City of Bell. If Mr. Lee and Best, Best and Krieger had advised us of a claim being handled by another law firm that could have an effect on the audited financial statements or disclosures, we would have followed up. There was no such disclosure include din Mr. Lee's response. We believe that our audit procedures (primarily confirmations with third party experts) met the standards of care for identifying litigation, claims and assessments.

The draft SCO report suggest that had we analyzed the $427,000 of legal expense recorded in the general ledger of the City, we would have noted that other firms were consulted besides Best, Best and Krieger. Local governments engage a variety of law firms for different purposes that are not relevant to the audit process. The auditor makes a determination of which law firms are dealing with matters significant to the determination of material matters affecting the financial statements based upon discussion with management so that requests for a response on such matters is sent to firms involved in matters where the City may be the defendant, in a case involving the potential reporting of a liability for claims and judgments. Had the $427,000 of legal fees been analyzed, the auditor would still have used the knowledge of

> management to ascertain the scope of service provided by each law firm. Such inquiry with management is appropriate and customary to assist the auditor in making a determination as to which law firms should be contacted to respond to audit inquiries regarding claims and judgments. The examination of every invoice paid during the fiscal year does not reflect the standard of care expected by GAGAS or GAAS with respect to the performance of local government financial statement audits.
>
> In summary, other than the placeholder typographical error on workpaper 4-3A, all documentation is in the electronic files or was referred to in the electronic files and can be easily validated by another experienced auditor.

SCO's Comment

The firm's response that we suggested that such communication regarding litigation be performed via e-mail or that if they were performed via e-mail, that a copy of the e-mail be provided in the working papers is not accurate. Auditing standards require that the auditor prepare documentation that enables an experienced auditor, having no previous connection to the audit, to understand the timing of procedures performed and audit evidence obtained (GAGAS 4.19). Since this information was not documented in the working papers we were unable to determine the date of the contact from the firm's audit working papers.

The firm's response indicates that the city may use a variety of law firms for different purposes that are not relevant to the audit process. However, the firm's response does not indicate why a legal representative who received $427,000 from the city was not relevant to the audit process and, therefore, not contacted. In addition, the firm did not document which law firms were dealing with matters significant to the determination of material matters affecting the financial statements.

At the December 3, 2010 exit conference, the firm stated that it relied on the city attorney's assertion that there were no contingent liabilities to be disclosed in the audit report because the city's attorney was considered to be an independent third party. However, as a third party, the attorney would not necessarily be aware of all of the city's litigation, claims and assessments. The working papers contained no evidence of how the firm determined that the city attorney was aware of all legal representatives' services.

In addition to its noncompliance with audit standards, the firm did not comply with section 5097 of the California Business and Professions Code as follows:

> (a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.

(b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.

(c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

Our finding and recommendation remain unchanged.

Noncompliance With OMB Circular A-133 Requirements

FINDING 6—Deficiencies in testing federal program compliance requirements

Our review of the firm's testing of federal compliance disclosed that it used the March 2008, instead of the March 2009, Office of Management and Budget (OMB) Circular A-133 Compliance Supplement to test major programs. The March 2009 Compliance Supplement was effective for audits of fiscal years beginning after June 30, 2008 (July 1, 2008, through June 30, 2009), and superseded the March 2008 Compliance Supplement.

Part 1 of the Compliance Supplement states, in part:

> OMB Circular A-133 provides that Federal agencies are responsible for annually informing OMB of any updates needed to this Supplement. However, auditors should recognize that laws and regulations change periodically and that delays will occur between such changes and revisions to this Supplement. Moreover, auditors should recognize that there may be provisions of contract and grant agreements that are not specified in law or regulation and, therefore, the specifics of such are not included in this Supplement. For example, the grant agreement may specify a certain matching percentage or set a priority for how funds should be spent (e.g., a requirement to not fund certain size projects). Another example is a Federal agency imposing additional requirements on a recipient because it is designated high-risk, in accordance with the A-102 Common Rule or an agency's implementation of Circular A-110 (now included at 2 Code of Federal Regulations [CFR] part 215) or as part of resolution of prior audit findings.
>
> Accordingly, the auditor should perform reasonable procedures to ensure that compliance requirements are current and to determine whether there are any additional provisions of contract and grant agreements that should be covered by an audit under the 1996 Amendments. Reasonable procedures would be inquiry of non-Federal entity management and review of the contract and grant agreements for programs selected for testing (i.e., major programs).

The March 2009 Compliance Supplement added to Section N, Special Tests and Provisions 4–Rehabilitation, a description of the Neighborhood Stabilization Program (NSP) compliance requirement and suggested audit procedure "c" as follows:

> Any NSP-assisted rehabilitation of a foreclosed-upon home or residential property shall be completed to the extent necessary to comply with applicable laws, codes and other requirements relating to housing safety, quality, or habitability, in order to sell, rent or redevelop such homes and properties. To comply with this provision, a grantee must describe or reference in its NSP action plan amendment what rehabilitation standards it will apply for NSP-assisted rehabilitation (Section 2301(d) (2) of HERA; Section II.I. of NSP Notice, 73 FR 58338). . . . c. For NSP projects, review rehabilitation standards.

The firm's compliance program did not contain the description of the NSP compliance requirement and the suggested audit procedure "c." In addition, the working papers did not contain evidence that the firm considered or performed this suggested audit procedure.

According to the March 2009 Compliance Supplement, the Community Development Block Grant (CDBG) is to be used for the acquisition of real property, construction, reconstruction and rehabilitation of facilities to meet community development needs. The firm's working paper, *CDBG Test of Transactions* states, "A significant amount of CDBG costs relate to salaries tested at working paper B-3." The Test of Transactions working paper does not explain why a significant amount of CDBG funds were used to pay the salaries of city employees when the funds were to be used for community redevelopment needs. The working paper referred to was actually BB-3, which documented the firm's testing of CDBG salary allocations. This working paper does not document the firm's testing to determine whether salaries were allowable. In addition, the working paper does not identify the dollar amount of the salaries; therefore, we are unable to determine the amount of salaries tested in relation to total salaries paid using CDBG funds.

American Recovery and Reinvestment Act of 2009

The OMB issued an addendum to the Compliance Supplement in August 2009, effective for audits beginning after June 30, 2008, that described additional compliance requirements for American Recovery and Reinvestment Act (ARRA) funds. There was no evidence in the working papers that the firm determined whether the city expended ARRA funds and was subject to the additional compliance requirements.

Our review also disclosed that the firm did not perform all suggested audit procedures for determining the city's compliance with specific federal requirements, as follows:

Allowable Costs

The Compliance Supplement requires the firm to determine whether the city complied with OMB Circular A-87 standards for determining allowable costs for federal awards. Circular A-87 requires the city to ensure that salaries and wages charged to federal programs are supported by certifications or personal activity reports. The firm performed tests to determine that payroll expenses were fairly stated; however, the firm's obligation to test compliance with federal requirements is not contingent on material misstatement. The firm's testing of CDBG salaries was limited to determining whether salaries were properly allocated to the various programs within the CDBG program. The firm did not determine whether the salaries were supported by certifications or personal activity reports, as required by Circular A-87. In addition, there was no evidence that the firm determined whether salaries charged to the CDBG program were authorized or adequately supported.

Davis-Bacon Act

The firm's Single Audit–Major Program Audit Program states, "per inquiry (of the CDBG consultant) and through review of the GL detail at 3/24/09 there were no such expenditures where the city was required to follow Davis-Bacon requirements." However, there was no evidence in the working papers that the firm followed up to determine whether any expenditures occurred between March 25 through June 30, 2009 (end of the audit period) that required compliance with Davis-Bacon Act requirements.

Program Income

The Compliance Supplement requires the firm to determine whether program income is correctly determined, recorded, and used in accordance with program requirements.

The firm's compliance requirement working paper states, "MHM inquired with the CDGB coordinator. All program income is returned to County of LA. MHM tested program income @ JJ-1." However, the working paper referenced, only indicated that the firm tested whether the city accurately accounted for the program income. The working paper did not indicate that the firm performed procedures to test for other compliance requirements related to program income, such as whether the use of income derived from loan payments is subject to program requirements. For example, the firm should have performed procedures to determine whether the city had a loan origination and servicing system in effect which assures that loans are properly authorized, receivables are properly established, earned income is properly recorded and used, and write-offs of uncollectible amounts are properly authorized.

Reporting

The Compliance Supplement requires the firm to determine whether required reports for federal awards include all activity of the reporting period, are supported by applicable accounting or performance records, and are fairly presented in accordance with program requirements.

Financial Reporting (revised based on information provided by the firm)

The auditor completed the audit procedure by stating "MHM materially agreed financial reports to SEFA @ LL-1." At working paper LL-1 the auditor had noted "Procedures: MHM reviewed quarterly *(performance)* reports and materially agreed to expenditures reported on the SEFA." The auditor concluded "No exceptions were noted in tying to SEFA." However, there were no tick marks or other identifiers to indicate which of the CDBG programs the auditor agreed to the SEFA.

The working papers included performance reports for various projects for all four quarters. The amounts reported on the SEFA are year-end totals so only the 4th quarter performance report would be expected to agree to the SEFA. We found that the 4th quarter performance reports did not agree to the SEFA and noted the following variances:

Community Development Block Grant (CDBG) Programs	CDBG Schedule of Expenditures of Federal Awards (SEFA)	CDBG 4th Quarter Performance Reports	Variance
Housing Rehabilitation	$ 137,627	$ 78,667	$ 58,960
Administration	42,071	Not in w/ps [1]	42,071
Graffiti Removal	99,795	99,795	0
Lead-Based Paint	11,290	11,094	196
Code Enforcement	282,568	0 [2]	282,568
Handyworker's Program	117,630	Not in w/ps [3]	117,630
Totals	$ 690,981	$ 189,556	$ 501,425

Expenditures reported on the 4th quarter performance reports amounted to $189,556, or 27.43%, of the expenditures reported on the SEFA, totaling $690,981. The firm's work did not support its conclusion that required reports for Federal awards include all activity of the reporting period, are supported by applicable accounting or performance records, and are fairly presented in accordance with program requirements. The variance between SEFA and the performance report was $501,425, in the aggregate. The firm calculated CDBG materiality level to be $35,000. The $501,425 variance clearly exceeded the $35,000 tolerable level for program noncompliance. There was no evidence that the firm identified or investigated any variance.

Procedure L in the Compliance Supplement states,

> L. Reporting
>
> **Audit Objectives**
>
> 1. Obtain an understanding of internal control, assess risk, and test internal control as required by OMB Circular A-133 §___.500(c).
>
> 2. Determine whether required reports for Federal awards include all activity of the reporting period, are supported by applicable accounting or performance records, and are fairly presented in accordance with program requirements.

[1] There was no performance report in the working papers that showed total CDBG administration expenses.

[2] The 4th quarter performance report for the code enforcement program showed no year-to-date expenditures. However, the 3rd quarter performance report showed year-to-date expenditures of $135,139.

[3] The 4th quarter performance report for the Handyworker's Program was not included in the working papers. The 1st, 2nd, and 3rd quarter reports showed expenditures of $0, $25,981 and $64,649, respectively.

Suggested Audit Procedures – Compliance

3. Select a sample of each of the following report types:

    a. Financial reports

        (1) Ascertain if the financial reports were prepared in accordance with the required accounting basis.

        (2) Trace the amounts reported to accounting records that support the audited financial statements and the Schedule of Expenditures of Federal Awards and verify agreement or perform alternative procedures to verify the accuracy and completeness of the reports and that they agree with the accounting records. If reports require information on an accrual basis and the entity does not prepare its accounting records on an accrual basis, determine whether the reported information is supported by available documentation.

Special Tests and Provisions (revised based on information provided by the firm)

The firm obtained the Community Development Commission (CDC) Citizen Participation Plan and concluded that the County's citizen participation plan governed the City of Bell also and therefore satisfied the citys' requirement to develop and implement a citizen participation plan. A note at working paper NN-1 stated "conclusion, the City of Bell is covered under the CDC's Citizen Participation Plan on p. 414."

The Los Angeles County Citizen Participation Plan states:

> The Los Angeles County Citizen Participation Plan is intended to ensure full citizen participation in the Los Angeles Urban County program. All community development, housing and emergency shelter activities, either proposed or currently being implemented under the CDBG, ESG, and HOME programs are governed by the provisions herein.
>
> The Citizen Particpation Plan sets forth the policies and procedures for citizen participation in Los Angeles County's Consolidated Planning Process. The CDC, as the lead agency for the Consolidated Plan, carries out the responsibilities for following the citizen participation process.

The firm did not examine the city's records for evidence that the elements of the citizen's participation plan were followed as required by Special Test and Provisions 1, Citizen Participation, Procedure C, in the March 2009 Compliance Supplement.

For example, the Los Angeles County Citizen Participation Plan states:

> Each participating city gives its constituency the opportunity to provide citizen input on housing and community development needs at a community meeting or public hearing by:
>
> - Holding one or more community meetings or conducting one public hearing with a minimum of 14 calendar day notification period.
> - Soliciting citizen participation through an advertisement published in local newspaper whose primary circulation is within the city.
> - Soliciting citizen participation through notices posed in public buildings within the city at least 14 calendar days before the meeting date.
>
> With submission of its planning documents to the CDC each year, participating cities are required to submit proof of city council approval of its proposed activities in one

The working papers contained no evidence that the auditor verified that a public meeting was conducted or that citizens were notified of meetings in advance as required by the participation plan.

In addition, the Compliance Supplement requires the firm to determine whether the grantee:

- Is obligating and expending program funds only after HUD's approval of the request for release of funds (RROF).
  - The firm's compliance requirement document states "N/A – no construction projects underwent during the year did not require RROF's from HUD." However, the firm's working paper for Cash Management – Request for Release of Funds Test work, indicate the two RROFs tested for cash management compliance. Because the working paper does not contain a description of the RROFs tested and the RROFs are not documented in the working papers we cannot determine whether the special tests and provision procedures applied and should have been performed.
- Determined whether environmental reviews are being conducted, when required.
  - The firm's compliance requirement document states "per inquiry with client and research completed, environmental reviews do not apply to the specific work the city does with CDBG funds." The working papers do not document with whom the auditor spoke or the sources researched that supported the firm's conclusion that the environmental reviews do not apply.

OMB Circular A-133, Subpart E, §__.500(d)(4) states:

> The compliance testing shall include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance.

OMB Circular A-87, Attachment B, 8.h. states, in part:

> Support for salaries and wages. These standards regarding time distribution are in addition to the standards for payroll documentation.
>
> (3) Where employees are expected to work solely on a single Federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program for the period covered by the certification. These certifications will be prepared at least semi-annually and will be signed by the employee or supervisory official having first hand knowledge of the work performed by the employee.
>
> (4) Where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation which meets the standards in subjection (5) unless a statistical sampling system (see subjection (6)) or other substitute system has been approved by the cognizant Federal agency. Such documentary support will be required where employees work on:
>
> (a) More than one Federal award,
>
> (b) A Federal award and a non Federal award,
>
> (c) An indirect cost activity and a direct cost activity,
>
> (d) Two or more indirect activities which are allocated using different allocation bases, or
>
> (e) An unallowable activity and a direct or indirect cost activity.

AU 339.03 states, in part:

> The auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached.

AICPA Guide on Audit Sampling, May 1, 2008 edition, Initial Testing, paragraph 3.11 states in part:

> When an auditor performs tests of controls during interim work, he or she should consider what additional evidence needs to be obtained for the remaining period. Where this is obtained by extending the test to transactions occurring in the remaining period, the population consists of all transactions executed throughout the period under audit.

Additional Federal Testing Deficiencies

(New deficiencies added based on information provided and comments made at the December 3, 2010 exit conference).

The firm did not adequately document its risk assessment of the city's Type B federal programs as follows:

The city had only one program, the CDBG program, which had expenditures that exceeded the $300,000 threshold for Type A programs. The firm determined the CDBG program to be low-risk; therefore, the

firm had to identify which Type B programs were high-risk programs. The auditor is not required to identify more high-risk Type B programs than the number of low-risk Type A programs. There were two Type B programs that exceeded the $100,000 threshold, for small Type B programs that required a risk assessment. These two programs were Public Safety Partnership and Community Policing Grants CFDA # 16.710 and Federal Asset Forfeiture CFDA # 21.000

- The firm concluded that the Public Safety Partnership and Community Policing Grant program was low-risk even though (1) the program had not been audited in the prior year, (2) this was the city's second year of participation in the program (program was new to the city) and (3) the federal Department of Justice identified this program as high-risk for FY 2008-09 audits as documented in the firm's High-Risk Federal Program Determination Worksheet. All of these factors increase the risk of program noncompliance with federal requirements.

- The firm made no risk determination on the Federal Asset Forfeiture program. This program had also not been audited in the prior two years. Part 1 of the March 2009 Compliance Supplement – Applicability, states, in part:

> . . . for major programs not included in this supplement, the auditor shall follow the guidance in Part 7 and use the types of compliance requirements in Part 3 to identify the applicable compliance requirements which could have a direct and material effect on the program.

Part 7 of the Compliance Supplement states, in part:

> OMB Circular A-133, §___.500 (d)(3) states that for those Federal programs not covered in the compliance supplement, the auditor should use the types of compliance requirements contained in the compliance supplement as guidance for identifying the types of compliance requirements to test, and determine the requirements governing the Federal program by reviewing the provisions of contract and grant agreements and the laws and regulations referred in such contract and grant agreements.

OMB Circular A-133 states:

> **§___.520 Major program determination.**
>
> (d) Step 3 states in part:
>
> (1) The auditor shall identify Type B programs which are high-risk using professional judgment and the criteria in §___.525. However, should the auditor select Option 2 under Step 4 (paragraph (e)(2)(i)(B) of this section), the auditor is not required to identify more high-risk Type B programs than the number of low-risk Type A programs. Except for known reportable conditions in internal control or compliance problems as discussed in §___.525(b)(1), §___.525(b)(2), and §___.525(c)(1), a single criteria in §___.525 would seldom cause a Type B program to be considered high-risk.

(2) The auditor is not expected to perform risk assessments on relatively small Federal programs. Therefore, the auditor is only required to perform risk assessments on Type B programs that exceed the larger of:

(i) $100,000 or three-tenths of one percent (.003) of total Federal awards expended when the auditee has less than or equal to $100 million in total Federal awards expended.

(ii) $300,000 or three-hundredths of one percent (.0003) of total Federal awards expended when the auditee has more than $100 million in total Federal awards expended.

(e) Step 4. At a minimum, the auditor shall audit all of the following as major programs:

(1) All Type A programs, except the auditor may exclude any Type A programs identified as low-risk under Step 2 (paragraph (c)(1) of this section).

(2) (i) High-risk Type B programs as identified under either of the following two options:

(A) Option 1. At least one half of the Type B programs identified as high-risk under Step 3 (paragraph (d) of this section), except this paragraph (e)(2)(i)(A) does not require the auditor to audit more high-risk Type B programs than the number of low-risk Type A programs identified as low-risk under Step 2.

(B) Option 2. One high-risk Type B program for each Type A program identified as low-risk under Step 2.

(ii) When identifying which high-risk Type B programs to audit as major under either Option 1 or 2 in paragraph (e)(2)(i)(A) or (B), the auditor is encouraged to use an approach which provides an opportunity for different high-risk Type B programs to be audited as major over a period of time.

(g) **Documentation of risk.** The auditor shall document in the working papers the risk analysis process used in determining major programs.

The firm has audited the same federal program, and only that program, since 2006.

In addition, the firm did not document in its working papers:

- An audit program for procedures included in Part 3 of the Compliance Supplement
- Procedures performed to test compliance requirements included in Compliance Supplement, Part 3. The working papers did not contain evidence that the firm tested:
  - Allowable Costs/Costs Principles – there was no evidence that the auditor determined if the city charged indirect costs to the CDBG program at the approved rate. (OMB Circular A-87);
  - Cash Management – there was no evidence that the auditor determined if the city earned interest on Federal funds, and if so,

that the funds were returned the awarding agency. (OMB Circular A-133);

If all required compliance procedures are not performed, the auditor's opinion on compliance may not be supported or accurate. In addition, noncompliance may have occurred but will not be identified and reported. The auditor's work does not support the firm's conclusion that the City of Bell complied with federal program requirements. As a result, the State and federal government cannot rely on the single audit to assure the City of Bell's compliance with federal requirements.

Recommendation

The firm should:

- Ensure that it applies the OMB Circular A-133 Compliance Supplement applicable to the audit period.
- Identify and apply any addenda to the Compliance Supplement that are applicable to the audit period.
- Perform all suggested audit procedures in the Compliance Supplement or document why the procedure was not applicable or whether alternative procedures were performed.
- Retain sufficient appropriate documentation to support the work performed, the audit evidence obtained and its source, and the conclusions reached.

Firm's Response

When our engagement audit team commenced planning and fieldwork in March, 2009 on the City of Bell audit, the March, 2009 supplement was not yet available and we utilized the 2008 compliance supplement in our audit files. The program objectives for the Department of Housing and Urban Development Community Development Block Grant, CFDA 14.218 in 2008 are exactly the same as the program objectives identified in the compliance supplement in 2009, with the exception of the Housing and Economic Recovery Act of 2008 (HERA). According to the 2009 Compliance Supplement, the use of NSP funds which were provided by HERA, to which additional compliance requirements would apply, include such activities as:

- Establish financing mechanisms for purchase and redevelopment of foreclosed upon homes and residential properties.
- Purchase and rehabilitate homes and residential properties that have been abandoned or foreclosed upon for later sale, rent or redevelopment.
- Establish land banks for homes that have been foreclosed upon.
- Demolish blighted structures
- Redevelop demolished or vacant properties.

When a Compliance Supplement is updated after the performance of preliminary audit work, we obtain the revised Supplement and compare the changed provisions to the Compliance Supplement that was utilized for the preliminary work performed. Where audit requirements changed for activities applicable to that client, we add the new or changed audit requirements to the Supplement utilized in our workpapers so that all relevant additional requirements will be attended to. Our comparison of the Supplement in effect during the planning stage of the audit and the Supplement in effect at the date of our opinion indicated that there were no significant additions or changes in compliance requirements or auditor testing responsibilities that required a reperformance of previously performed audit testing or the addition of further procedures.

In particular, it should be noted that the City of Bell did not use any of their CDBG funds for the activities identified above, nor was any of the City's CDBG grants funded through the HERA program. As a result, the additional program objectives and related compliance requirements associated with HERA were not applicable to the City of Bell and did not have a direct and material impact on the risk nature of the CDBG grant program as it related to the City of Bell for the year ended June 30, 2009. Accordingly, we did not modify the Compliance Supplement in use by our firm for the City of Bell audit to reflect the addition of audit steps that would not be applicable to the federal funding received by the City of Bell.

As of March 24, 2009, the City of Bell had incurred $479,397 of CDBG expenditures as documented at BB-2.1. Of the $479,397 of expenditures, $174,875 of expenditures were incurred from non-payroll activities. Our testing of the City's internal controls over this program included the testing of $73,000 of non-payroll expenditures incurred as of March 24, 2009, which represented 42% of expenditures incurred to that date. Our documentation of the controls in place and our testing of those controls as performed at workpaper BB-2.3 identified no instances of non-compliance which demonstrated that the City internal controls over the CDBG program were operating effectively. The additional expenditures of $211,584 incurred from March 25, 2009 through June 30, 2009 were consistent with the activities tested in the first 9 months of the fiscal year and based on our testing performed; the internal controls over the CDBG program had not changed (e.g. key controls were unchanged and the personnel executing the key controls were the same experienced city staff) and were still effective which would not result in the need to test additional amounts. Of the $211,584 of expenditures incurred from March 25, 2009 through June 30, 2009, $113,433.71 of expenditures were incurred for the similar activities which were tested at workpaper BB-2.3.

Of the $479,397 of CDBG expenditures incurred as of March 24, 2009 as noted at workpaper BB-2.1, $304,521 of expenditures were from City staff payroll charges. These payroll expenditures represented the work of 9 City employees, of which 8 spend 100% of their time working on CDBG activities mainly consisting of Code Enforcement Officers and the Handyman and Rehabilitation program. Due to the fact that these 8 employees spent 100% of their time performing activities to allow the City to meet the program objectives of the CDBG program, there was no allocation of their salaries to any other department or program of the City. The one individual that was not 100% dedicated to the CDBG program had 44% of that individual's salary allocated to

CDBG as a Code Enforcement Officer. Our workpapers documented at workpaper BB-3 that based on this individual's job duties, a 44% allocation was reasonable. In addition, according to the grant agreement with the County, these positions were budgeted for and approved by the County for the City's comprehensive code enforcement services in deteriorating areas to support rehabilitation and public improvement projects. The County of Los Angeles Community Development Commission approved the City's budget and contract No. 103329 which included the funding of these code enforcement officers to allow them to investigate approximately 45 cases, commercial and residential, per month. This audit documentation was in a manual workpaper bulk file provided to the SCO as an integral part of our workpapers.

AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

The City of Bell did not receive any grants or contracts associated with the American Recovery and Reinvestment Act of 2009 during the 2009 fiscal year. The addendum to the Compliance Supplement issued in August of 2009 addressed specific issues which pertained to ARRA funded programs. The City of Bell did not have any such programs. Through our inquiry of City staff, our review of the City staff prepared Schedule of Expenditures of Federal Awards workpaper SA-3-3, and our review of the City's trial balances, there was no indication that the City received ARRA funds which resulted in the addendum to the 2009 Compliance Supplement having a direct or material impact on the City federal award programs.

ALLOWABLE COSTS

As discussed, the City had 9 employees that charged time to the CDBG program; of those 9, 8 employees were directly charged to the program for 100% of their salaries. These 8 individuals did not have their time or costs allocated to any other department or program of the City. The one City Staff that had a portion of that individual's salary allocated to the CDBG program was 44% of the time, which our workpapers documented at workpaper BB-3 that based on this individuals job duty, the 44% allocation was reasonable. We believe that the audit procedures performed were adequate to insure that allocated salaries to the CDBG program were allowable costs and in compliance with OMB Circular A-133 and Circular A-87. Our audit procedures included a review of the City's grant agreement with the County, (Contract 103329 in our audit manual bulk file provided to the SCO), which specifically identified the individuals and their salaries approved to be charged to the CDBG program, and an interview with the one employee who's time was not 100% allocated to the program to document that the individuals job duties and day to day responsibilities were consistent with the allocation percentage used.

DAVIS BACON ACT

Per the Compliance Supplement, the requirements of the Davis-Bacon Act apply to the rehabilitation of residential property only if such property contains 8 or more units. However, the requirements do not apply to volunteer work where the volunteer does not receive compensation, or is paid expenses, reasonable benefits or a nominal fee for such services, and is not otherwise employed at any time in construction work (42 USC 5310; 24 CFR section 570.603). Based on

the testing performed through March 24, 2009, the City did not engage any outside companies to perform construction work for the rehabilitation of residential property with 8 or more units, which caused in the Davis Bacon Act Compliance to not be an applicable compliance area for the City of Bell's CDBG program. As of March 24, 2009, the City incurred $174,875 of non-payroll expenditures of which $73,000 was tested for being allowable and within the program objectives and requirements. From March 25, 2009 to June 30, 2009, the City's administration of the CDBG program was not changed, nor did the City spend or contract with any company to perform construction work, which would have made this compliance area applicable. Additionally, had the City made a decision to change their program activities to include such work as the rehabilitation of residential properties of 8 or more units, evidence of this commitment would have been identified in our review of Council minutes or through our inquires of management, which did not exist and did not occur. Furthermore, based on our review of the final trial balances at TB.1, (a paper file that was part of the bulk documents provided to the SCO), there were no new accounts nor were there any significant changes to the activities of this program. As such, our testing of controls and evaluation of the applicability of the Davis Bacon Act was unchanged as of June 30, 2009. The Davis Bacon Act compliance requirement was not applicable to the City of Bell CDBG program.

PROGRAM INCOME

As stated by the SCO, our compliance testing documented at workpaper JJ-1 indicated that our testing demonstrated that the City was accurately accounting for program income. Documentation and interviews with the contract CDBG Coordinator at workpaper LL-4 supported that internal controls over program income were operating effectively. During the year ended June 30, 2009, one loan for $20,000 was repaid, which is program income. However, per the compliance supplement, testing of program income is only needed if program income exceeds $25,000. The guidance specifically states:

> The grantee must accurately account for any program income generated from the use of CDBG funds and must treat such income as additional CDBG funds which are subject to all program rules. Program income does not include income received in a single program year by the grantee and all of its subrecipients if the total amount of such income does not exceed $25,000 (emphasis added) (24 CFR sections 570.500, 570.504, and 570.506).

As such, our testing of this area was appropriate and in compliance with OMB Circular A-133 and the 2009 compliance supplement. Program Income compliance requirement was not applicable to the City of Bell CDBG program, and did not have a direct and material impact on the federal program for the year ended June 30, 2010.

FINANCIAL REPORTING

Our workpaper documentation at workpaper LL-4 discusses the process that we documented regarding the CDBG Funding Request (which we believe is equivalent to SF-272 Federal Cash Transactions Report). We interviewed program personnel and documented controls over claims and financial reporting. We believe this to be adequate documentation.

The testing of the City's performance reporting consisted of insuring the amounts of expenditures reported agreed to the underling accounting records, which we performed and documented at workpaper LL-2. This testing was only performed as an audit procedure to verify the amounts reported in the client's Schedule of Federal Awards, and not as a test of controls or compliance with the provisions related to performance reporting.

The performance reporting compliance requirement for the CDBG program per the 2009 Compliance Supplement requires that only prime recipients comply with the HUD 60002, Section 3 Summary Report, Economic Opportunities for Low- and Very Low-Income Persons (OMB No. 2529-0043). The City of Bell is a subrecipient from the County of Los Angeles. The County of LA is responsible for this reporting requirement, not the City of Bell. As such, this compliance step was not applicable to the City.

> HUD 60002, *Section 3 Summary Report, Economic Opportunities for Low- and Very Low-Income Persons, (OMB No. 2529-0043)* – For each grant over $200,000 that involves housing rehabilitation, housing construction, or other public construction, the prime recipient must submit (emphasis added) Form HUD 60002. (24 CFR sections 135.3(a), 135.90, and 570.607).

SPECIAL TESTS AND PROVISIONS

The City of Bell, as a subrecipient of CDBG funds from the County of Los Angeles, is included in the County's Citizen Participation Plan (documented at workpaper NN-1), and the activities documented as part of the County's plan and included in the grant agreement are consistent with the program objectives. Our testing of the grant agreement, the County of Los Angeles Monitoring report and the Citizen Participation Plan clearly indicate that the City has developed and implemented an appropriate Citizen Participation Plan.

The compliance requirements relating to the request for release of funds (RROF) and environmental reviews are not applicable to the City of Bell's CDBG program. These approvals and reviews are exempt, per CFR 24, Section 58.35(a)(3) as noted below.

> Title 24 - Housing and Urban Development Subtitle A - Office of The Secretary, Department of Housing and Urban Development
>
> Part 58 - Environmental Review Procedures For Entities Assuming HUD Environmental Responsibilities
>
> Subpart D - Environmental Review Process: Documentation, Range of Activities, Project Aggregation and Classification
>
> 58.35 - Categorical exclusions.
>
> Categorical exclusion refers to a category of activities for which no environmental impact statement or environmental assessment and finding of no significant impact under NEPA is required, except in extraordinary circumstances (see 58.2(a)(3)) in which a normally excluded activity may have a significant impact. Compliance with the other applicable Federal environmental laws and authorities listed in 58.5 is required for any categorical exclusion listed in paragraph (a) of this section.

(a) Categorical exclusions subject to 58.5. The following activities are categorically excluded under NEPA, but may be subject to review under authorities listed in 58.5: (1) Acquisition, repair, improvement, reconstruction, or rehabilitation of public facilities and improvements (other than buildings) when the facilities and improvements are in place and will be retained in the same use without change in size or capacity of more than 20 percent (e.g., replacement of water or sewer lines, reconstruction of curbs and sidewalks, repaving of streets).

(3) Rehabilitation of buildings and improvements when the following conditions are met: (i) In the case of a building for residential use (with one to four units), the density is not increased beyond four units, the land use is not changed, and the footprint of the building is not increased in a floodplain or in a wetland; (ii) In the case of multifamily residential buildings: (A) Unit density is not changed more than 20 percent; (B) The project does not involve changes in land use from residential to non-residential; and (C) The estimated cost of rehabilitation is less than 75 percent of the total estimated cost of replacement after rehabilitation.

(b) Categorical exclusions not subject to 58.5. The Department has determined that the following categorically excluded activities would not alter any conditions that would require a review or compliance determination under the Federal laws and authorities cited in 58.5. When the following kinds of activities are undertaken, the responsible entity does not have to publish a NOI/RROF or execute a certification and the recipient does not have to submit a RROF to HUD (or the State) except in the circumstances described in paragraph (c) of this section. Following the award of the assistance, no further approval from HUD or the State will be needed with respect to environmental requirements, except where paragraph (c) of this section applies. The recipient remains responsible for carrying out any applicable requirements under 58.6.

SCO's Comment

The firm's comparison of the Compliance Supplement in effect during the planning stage of the audit and the Compliance Supplement in effect at the date of the audit opinion was not documented in its working papers.

The firm's response indicates that the city did not use any of its CDBG funds for the activities requiring additional compliance testing. However, the firm did not document how its determination that the city's expenditures did not include such activities as listed in the Compliance Supplement.

In addition, the firm indicated that it performed fieldwork in March of 2009. Therefore, its expenditure testing did not include all transactions for the fiscal year. To be representative of the total population; all transactions in the fiscal year (scope of the audit) and all items in the

population must have an equal chance to be selected. Therefore, the firm's sample was not representative of the total population.

AU 350.24 states, in part:

> Sample items should be selected in such a way that the sample can be expected to be representative of the population. Therefore, all items in the population should have an opportunity to be selected. . . .

In addition, the firm did not comply with AU 311.34, Appendix A2, which states, in part:

> The auditor may consider the following matters when establishing the scope of the audit engagement:
>
> - The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect of the information obtained during such reviews.

The firm's working papers for CDBG tests of transactions do not contain a reference to the grant agreement with the county referred to in the firm's response. The firm did not document its consideration of salaries as an allowable activity.

American Recovery and Reinvestment Act of 2009

The firm's response does not indicate where it documented its consideration of the addendum to the Compliance Supplement and determination that the city did not receive ARRA funds.

Allowable Costs

OMB Circular A-87 requires that time certifications or personnel activity reports be completed to support salaries and wages charged to federal programs. The firm's response does not indicate that it tested compliance with this requirement. The requirement for time certifications and personnel activity reports is an additional requirement for allowable costs.

Davis-Bacon Act

There are no working papers to support the firm's determination that the city did not spend or contract with any company to perform construction work which would have made compliance with the Davis-Bacon Act necessary for expenditures which occurred between March 25, and June 30, 2009.

Program Income

The firm's response indicates that program income compliance testing was not required because the $20,000 repayment received did not meet the $25,000 threshold for program income testing. However, as the firm did not document that it had determined whether the city had a loan origination and servicing system in effect, we cannot be assured that the

firm identified all program income. As the firm did not document the scope of its testing, we cannot determine which accounts and funds were reviewed to identify program income. In addition, the firm's response did not indicate how it determined compliance with other requirements related to program income as described in this deficiency.

Reporting

Financial Reporting

We revised this deficiency based on the additional documentation provided by the firm. However, the firm's working paper LL-4 discussing the process used for CDBG funding requests cannot be used to support that reports for federal awards included all activity of the reporting period, are supported by applicable accounting or performance records, and are fairly presented in accordance with program requirements.

Special Tests and Provisions

We revised this deficiency based on the additional documentation provided by the firm. However, as discussed in the revised deficiency, there is no evidence that the firm determined the city implemented the applicable provisions of the Citizen Participation Plan as required by the March 2009 Compliance Supplement.

The firm's response indicates that the compliance requirements relating to the request for release of funds and environmental reviews are not applicable to the city; however, the firm did not document this in the working papers.

The lack of documentation prevented us from understanding the conclusions reached by the firm. Therefore, we were unable to determine the audit procedures performed and the results of those procedures.

In addition to its noncompliance with audit standards, the firm did not comply with section 5097 of the California Business and Professions Code as follows:

> (a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.
>
> (b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand

> the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.
>
> (c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

Our finding was revised after reviewing additional information provided by the firm in its response to the deficiencies we identified in the firm's testing of the Reporting and Special Tests and Provisions compliance requirements. The revised finding clarifies the testing performed by the firm for these requirements and, based on our review of the additional information, the deficiencies we identified. Our recommendation remains unchanged.

FINDING 7— Deficiencies in evaluating internal controls over major federal programs

Our review disclosed that the firm documented its understanding of the internal controls over major federal programs pertaining to the compliance requirements for the CDBG program, and concluded that internal controls were to be relied upon and control risk was assessed at less than maximum.

Based on our review, we identified the following deficiencies:

- As noted above, the firm assessed control risk at less than maximum. However, OMB Circular A-133, Subpart E – Auditors §__.500(c) requires the auditor to perform procedures to obtain an understanding of internal control over federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs and to plan and perform testing of internal controls. In addition, the August 1, 2008 AICPA Audit Guide – *Government Auditing Standards* and Circular A-133 Audits states, in part, that the auditor should plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.

  In our judgment, assessing control risk at less than maximum is not synonymous with assessing control risk as low.

- Although the firm obtained an understanding of internal control over cash disbursements, the firm did not plan or perform tests of internal controls to support the firm's conclusion that internal controls were effective and can be relied upon. In addition to obtaining an understanding of internal controls over federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs, the firm was required to plan the testing of internal controls to support a low level of control risk and, unless internal control is likely to be ineffective, perform testing of internal controls.

  For cash disbursements, the firm documented its understanding of internal control; however, the working papers did not contain evidence that the firm adequately planned or performed tests of internal controls. The firm performed compliance tests of CDBG transactions, and as part of that testing, determined whether expenditures were supported by appropriate documentation; however, the firm did not perform other tests of internal controls, such as testing for proper approval by a person having knowledge of the program.

OMB Circular A-133, Subpart E – Auditors §__ .500(c) Internal Control states:

> (1) In addition to the requirements of GAGAS, the auditor shall perform procedures to obtain an understanding of internal control over Federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs.
>
> (2) Except as provided in paragraph (c) (3) of this section, the auditor shall:

(i) Plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program; and

(ii) Perform testing of internal control as planned in Paragraph (c) (2) (i) of this section.

If tests of internal controls over major federal programs are not planned and performed, the auditor might rely on controls as being effective when the controls are ineffective. The extent and scope of compliance testing performed may be inadequate because the auditor relied on ineffective internal controls.

Recommendation

The firm should:

- Plan and document the testing of internal controls over major federal programs to support a low assessed level of control risk.
- Perform testing of internal control as planned.
- Distinguish, in the working papers, the audit objectives, test results and test conclusions for internal controls and compliance attributes tested.
- Ensure that the sample size is the larger of the samples that would have been designed if the control and compliance samples were tested separately.

Firm's Response

CASH DISBURSEMENTS

We disagree with the SCO conclusion that we did not plan or perform tests of internal controls. In addition to documenting our understanding of internal controls over the Community Development Block Grant (CDBG) expenditures, we documented in workpapers AA-1 and BB-1 that CDBG grant expenditures are handled through the normal City cash disbursement process and workpapers AA-1 and BB-1 also referred to the test of controls workpaper over non-payroll transactions. The CDBG internal control documentation workpapers also state that payroll expenditures are handled through the normal City payroll process and refer to the test of controls workpaper over payroll transactions. In addition, we performed dual purpose tests of transactions to support a low level of control risk and to also substantively address a significant percentage of grant dollars expended. The tested transactions supported the strength of internal controls that were evaluated in our audit. These transactions were found to be in conformity with applicable compliance requirements, thereby demonstrating the effectiveness of program controls that were applied to these transactions.

Per the AICPA Audit and Accounting Guide, Governmental Audits and Circular A-133, AAG-SLA 9.22 indicates the following as it relates to testing of internal controls over major Federal programs:

> Circular A-133 states that the auditor should plan the test of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. Professional standards do not define or quantify a low assessed level of control risk of noncompliance. Therefore, professional judgment is needed in determining the extent of control testing necessary to obtain a low level of control risk of noncompliance.

ELIGIBILITY

The workpaper referenced in the SCO's report is related to the Special Tests and Provisions section of the compliance supplement related to Rehabilitation, not Eligibility. We included the following statement in our internal control documentation at workpaper AA-1: "N/A – not an applicable area as per compliance requirement" which agrees with the SCO's comments that eligibility requirements are not applicable to the CDBG program. Accordingly, there was no issue of deficiency on this issue with respect to audit documentation.

FINANCIAL REPORTING

The auditing standards allow the auditors to limit the amount of substantive testing they perform if they assess control risk as low by testing controls. In fact, we tested all material CDBG Funding Requests at workpaper LL-3 (a manual document provided as a part of our bulk file to the SCO). Testing all material CDBG Funding Requests provides greater evidence that reports were filed in accordance with federal requirements. Our dual purpose testing of these funding requests met not only the substantive objectives of the test, but also provided evidence of the quality of internal controls surrounding the preparation of the funding requests by noting the results of the application of internal control with respect to the funding requests tested (i.e., those internal controls resulted in funding requests tested by the auditors to be properly prepared and in conformity with the requirements for their preparation).

SCO's Comment

Cash Disbursements

The firm's response states that it performed dual-purpose tests of transactions to support a low level of control risk as well as to substantively address a significant percentage of grant dollars expended. The six transactions tested in the working papers, "CDBG test of transactions" totaled $73,000, which was only 10.6% of CDBG expenditures. Paragraphs 11.52 and 11.55 in the AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits,* state that the size of a sample designed for dual purposes should be the larger of the samples that would otherwise have been designed if the control and compliance samples were performed separately. In addition, the auditor's documentation of internal control and compliance tests should be distinguished from one another so there is a clear distinction between the

audit objectives and test results for each test so that separate conclusions may be reached on the internal control attributes and compliance attributes tested. The auditor did not document why the sample size of 10.6% was adequate to satisfy both objectives, and the audit documentation did not clearly distinguish the audit objectives and test results for the internal control attributes and compliance attributes tested.

In addition to its noncompliance with audit standards, the firm did not comply with section 5097 of the California Business and Professions Code as follows:

> (a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.
>
> (b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.
>
> (c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

Eligibility

Based on the additional information provided by the firm, this deficiency has been removed.

Financial Reporting

Based on the additional information provided by the firm, this deficiency has been removed.

Our finding has been revised to remove the deficiencies noted for Eligibility and Financial Reporting. Our recommendation has been revised to state that the firm should plan and document (emphasis added) its testing of internal controls over major federal programs to support a low assessed level of control risk. If the firm uses dual-purpose tests for internal control testing and compliance testing it should:

- Distinguish, in the working papers, the audit objectives, test results and test conclusions for internal controls and compliance attributes tested.
- Ensure that the sample size is the larger of the samples that would have been designed if the control and compliance samples were tested separately.

Noncompliance With Redevelopment Agency Audit Guide Requirements

FINDING 8—Audit documentation and evidence deficiencies

Our review found that the audit report did not include a finding that the Bell Community Redevelopment Agency was on the SCO sanction list for not making its outstanding pass-through payments to the local education agencies.

Specifically, Assembly Bill (AB) 1389 (Chapter 751, Statutes of 2008) requires redevelopment agencies (RDAs) to file two reports with county auditors regarding pass-through payments to affected agencies and the SCO to place RDAs that have outstanding pass-through payment liabilities to local education agencies on a sanction list. When an RDA is on the list, the following sanctions apply:

1. The redevelopment agency is prohibited from adding new project areas or expanding existing project areas;
2. The redevelopment agency is prohibited from issuing new bonds, notes, interim certificates, debentures, or other obligations; and
3. The redevelopment agency is only allowed to encumber funds or expend money for specified purposes. Also, the amount to be expended for monthly operations and administration may not exceed 75% of the average monthly amount spent for those purposes in the previous fiscal year.

Furthermore, there was no evidence in the firm's working papers that the auditor identified or considered the potential impact of AB 1389 on the agency's financial statements when designing the audit procedures or tested for violations of the sanctions. Our review of the agency's expenses disclosed that administrative expenses increased by 31% when compared to FY 2007-08, which is a violation of sanction 3 listed above.

There were seven procedures (procedures 9, 10, and 12 through 16) in the firm's RDA audit program where the auditor's initials and date performed were completed but there were no references or links to the working papers that support the actual work performed and conclusions reached.

AU section 317 and GAGAS 4.28 require the auditor to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from illegal acts (that is, violations of laws and regulations) that have a direct and material effect on the determination of financial statement amounts. This involves identifying

the laws and regulations that may have a direct and material effect on the financial statement amounts, and then assessing the risk that noncompliance with these laws and regulations may cause the financial statements to contain a material misstatement.

AU section 339.10 states, in part:

> The auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand:
>
> *a.* The nature, timing, and extent of auditing procedures performed to comply with SASs and applicable legal and regulatory requirements;
>
> *b.* The results of the audit procedures performed and the audit evidence obtained;
>
> *c.* The conclusions reached on significant matters; and
>
> *d.* That the accounting records agree or reconcile with the audited financial statements or other audited information.

Finally, although the Guidelines for Compliance Audits of California Redevelopment Agencies (RDA Audit Guide) does not include specific procedures for every requirement, the guidelines are not an all-inclusive manual of audit procedures. The guide does state that in all audits, the auditor must inquire about the existence of any special legislation that may materially affect the particular redevelopment agency under audit and consider its impact on the selection of audit procedures. Basically, there is no "safe harbor" for an independent auditor to justify not exercising professional judgment regarding the selection of auditing procedures.

As the firm did not disclose that Bell Community Redevelopment Agency was on the sanction list, test for compliance with AB 1389 or provide sufficient audit evidence to support its conclusion as to the agency's compliance with laws and regulations, the State cannot rely on the firm's conclusion that the Bell Community Redevelopment Agency had no instances of noncompliance or other matters that should be reported.

Recommendation

The firm should comply with audit standards as follows:

- Identify and design audit procedures to test compliance with laws and regulations that may have a direct and material effect on the financial statements.

- Ensure that audit staff prepares audit documentation in accordance with standards.

Firm's Response

We disagree with the SCO conclusion that the "temporary" listing of the Bell Community Redevelopment Agency on the SCO listing of sanctioned Redevelopment Agencies was a matter of non-compliance that would have had a direct and material effect on the financial statements of the Bell Community Redevelopment Agency for the year ended June 30, 2009. The following are the reasons:

- On July 7, 2009, the SCO made a report to the legislature of the State on Property Tax-Pass-through Payments-Health & Safety Code Section 33684.
- In the SCO report of July 7, 2009, the Bell Community Redevelopment Agency was one of 19 Agencies in the State that had not received concurrence with their County Auditor-Controller on their pass-through payments. On Page 80 of the SCO report to the legislature, the reason listed was "Dispute Type #16". On Page 79, the description of dispute issues was "Agency disagrees with the base years used in the calculations."
- As indicated by the SCO report, this was an issue of legal dispute, not a reportable instance of non-compliance.
- On Page 79 of the SCO report to the legislature, the SCO stated "neither the SCO nor any other state agency has provided instructions on how to resolve disputes."
- The amount of the base year pass-through in question that was in dispute with the Bell Community Redevelopment Agency was:

LA Community College	$ 7,658
LA County Office of Education	1,186
LA Unified School District	8,396
Montebello Unified School District	46,526
	$63,766

  The LA County Auditor-Controller and the Finance Staff of the Bell Community Redevelopment Agency subsequently resolved the dispute. The Bell Community Redevelopment Agency was removed from the listing as of September 1, 2010.

- The Review Report of selected transactions issued by the SCO for July 1, 2000 through June 30, 2010 (10 years of review) released final on October 20, 2010 to the City of Bell Interim City Administrator, Pedro Carrillo, made no mention of Health and Safety Code Section 33684 on AB 1389 issues because they were legal issues that had been resolved.
- The City of Bell Legal Representation Letter at workpaper 43(b) and follow-up correspondence (Attachment #6) made no mention of any material non-compliance issues.
- The City of Bell Management Representations as of December 18, 2009 (Attachment #9) made no mention of any matters of material non-compliance.

The SCO has referred to the extensive documentation that we completed to comply with Redevelopment Agency Audit Guide Requirements. However, the SCO has questioned audit program sign-off for seven procedures (9, 10 and 12-16) in our audit program.

- Step 9 clearly referred to workpaper R-3 series where we tested the largest project/expenditure charged to the fund. Step 9 clearly referred to a conclusion to our testing. Our conclusion was "Based upon the testwork performed, the single largest expenditure in the low-mod fund resulted in no construction or rehabilitation of affordable housing or eliminated specific conditions jeopardizing the health and safety of low and moderate housing residents for fiscal year end June 30, 2009."
- Step 10 - We noted no material expenditures in our testing of expenditures for expenditure outside the project area. We referred to R-3 series as noted in the conclusion above. We signed off the audit step and believe our audit work met professional standards.
- Step 12 – Our audit documentation clearly indicates at workpaper 4-2A that our audit team reviewed documentation supporting the City Clerk's production of minutes. We reviewed redevelopment agency minutes from July 1, 2008 through the date of our audit report.
- Step 13 and 14 in our audit program refer to a compliance request list that was completed and returned to our audit staff by the DAS of the City of Bell. Step 6 of our questionnaire at R-2, documented by Bell City Staff, indicated no changes were made in public notification notices procedures. Our documentation completed and provided by the Director of Administrative Services at workpaper R-2 also indicates that all public disclosure notices were made and there had been no changes in procedures during the year per workpaper R-2. We believe our documentation supported our audit steps being signed off.
- Step 15 - We previously provided the SCO with the Bell Redevelopment Agency Conflict of Interest Policy RDA Permanent File III-3-1. We believe the Conflict of Interest Policy appropriately addresses Government Code 87300, Title 9, chapter 7 of the Government Code and other questions intended in the compliance audit step. We believe our audit sign off and documentation was appropriate. Other steps in our audit program at Step 15 referred to the questionnaire completed under the supervision of the City's DAS and provided as documentation at workpaper R-2. All audit steps were completed appropriately.
- Step 16 referred to by the SCO clearly documented by our engagement team regarding Land Held for Resale and discussions with the client (Senior Accountant) indicated that no land was sold during the year. Further, documentation at D-5 of the Land Held for Resale workpaper prepared by the City's Senior Accountant indicated that there was no property held for resale sold during the year. Our review of Redevelopment Agency minutes also supported this assertion by City management and our conclusion. All conclusions and documentation were appropriate.

Finally, based upon the foregoing explanations, we believe that the SCO can rely upon the compliance audit work supporting our opinion on compliance for the year ended June 30, 2009.

SCO's Comment

Our finding did not address in any way whether the Bell Community Redevelopment Agency's inclusion on the sanction list would have a direct and material effect on its financial statements. Our finding mainly dealt with the fact that this should have been reported by the firm as a non-compliance finding.

The firm's response included a number of reasons for its disagreement with our finding; however, these reasons did not specifically address the main issue. Our finding was that the firm's audit report did not disclose that the Bell Community Redevelopment Agency was on the SCO's sanction list. The firm's response mainly dealt with the reasons as to why the Bell Community Redevelopment Agency should not have been included on the sanction list. The sanction was removed as of September 1, 2010; however, our review was for the 2008-09 fiscal year.

At the December 3 exit conference and in its December 8, 2010 letter, the firm stated that the Bell Community Redevelopment Agency was placed on a sanction list on July 7, 2009, which was after the end of the audit period covered by its audit report. Although, the Bell Community Redevelopment Agency was placed on the sanction list a few days after the end of the audit period, this was still several months prior MHM's audit report date of December 19, 2010. Therefore, this was a subsequent event that should have been evaluated by the firm and disclosed in the audit report as required under Guidelines for Compliance Audits of California Redevelopment Agencies.

Sanctions apply when an agency is on the list. The redevelopment agency is only allowed to encumber funds or expend money for specified purposes. Also, the amount to be expended for monthly operations and administration may not exceed 75% of the average monthly amount spent for those purposes in the previous fiscal year. Our separate review of the RDA's 2008-09 fiscal year expenses disclosed that administrative expenses increased by 31% when compared with fiscal year 2007-08. This is a violation of sanction 3 in AB 1389 as well as a compliance finding.

Further, the firm's reasons for stating that the RDA should not have been on the sanction list were not documented in its working papers.

The audit program included in the firm's working papers did not contain the working paper references the firm noted in its response to our draft report. As stated in our finding, the audit program contained the auditor's initials and dates but did not include references or links to the working papers where the compliance testing of the RDA was documented. During our exit conference we were directed to the working papers where the RDA compliance testing was documented. It should be noted that the RDA compliance testing consisted of only one transaction totaling $14,863. The total administrative charges were $161,313. After reviewing the appropriate working papers, it appears that although limited work was performed and documented, it was not properly referenced to the audit program.

In addition to its noncompliance with audit standards, the firm did not comply with section 5097 of the California Business and Professions Code as follows:

> (a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs,

> analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.
>
> (b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.
>
> (c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

Our finding was revised to clarify that the audit report did include a finding that the RDA was on the sanction list. Our recommendation remains unchanged.

FINDING 9—Noncompliance with the Redevelopment Agency Audit Guide

Our review of the firm's expenditure testing disclosed that the firm:

- Did not adhere to the RDA Audit Guide and its own audit program to review expenditures for items such as planning, administrative expenditures, salaries, or administrative overhead.
- Did not verify that the city prepared a written determination showing that the planning and administrative expenditures were necessary for the production, improvement, or preservation of low- and moderate-income housing.
- Did not review or test any expenditures from March 27 through June 30, 2009, for compliance.

Procedure 9 in Section B—Affordable Housing—in the RDA Audit Guide requires the auditor to determine whether planning and administrative expenditures were made from the Low and Moderate Income Housing Fund. If the expenditures were made, the auditor is to verify that the agency prepared a written determination showing that the planning and administrative expenditures were necessary for the production, improvement, or preservation of low- and moderate-income housing. Also, the auditor is to test the expenditures, as necessary, to verify their eligibility.

In addition, Procedure 18 in the firm's California Redevelopment Agency audit program directs the auditor to:

> Determine by scanning the expenditure reports for the low/moderate housing funds for line items such as salary expense or administrative overhead whether material planning and administrative expenditures

> were made from the Housing Fund. If these expenditures were made, verify that the agency has prepared a written determination showing that planning and administrative expenditures were necessary for the production, improvement, or preservation of low and moderate income housing. Test the expenditures, as necessary, to verify eligibility. Health and Safety Code 33334.3(d). This determination must be made annually in writing. Mount up a copy of the written determination.

On working paper R-3.1, the auditor noted that he/she performed the following procedures:

- Obtained Low/Mod Expenditure Detail for the period from 7/1/08 to 3/26/09.
- Reviewed report to determine the most significant expenditures.
- Determined if the most significant expenditures resulted in the construction or rehabilitation of affordable housing or eliminated specific conditions jeopardizing health or safety as described in the Health and Safety Code.
- Documented inquiry with management.

The working paper shows that the auditor tested 13.16%, or $14,863, of total fund expenditures as of March 26, 2009, by selecting the largest project/activity expenditure—Special Departmental Supplies. The auditor then inquired of management the purpose for the expenditures, observed the detail report, and determined that the expenditures were in compliance with the Health and Safety Code. The auditor concluded that, "Based on the test work performed, the single largest expenditure in the Low/Mod fund directly resulted in construction or rehabilitation of affordable housing or eliminated specific conditions jeopardizing the health or safety of existing low and moderate income residents in FYE 6/30/09."

Findings 1 and 3 in the State Controller's October 20, 2010 review report of selected RDA transactions disclosed that, for FY 2008-09:

- Administrative costs charged to the Low and Moderate Income Fund were unallowable.
- Other charges, such as a 20% county administrative fee, pager and cellular fees, vacation paid in lieu, etc., were charged to the Low and Moderate Income Housing Fund.

These unallowable or questionable expenditures were noted during the SCO's perusal of the city's expenditure ledgers.

SCO's review further disclosed that the city was unable to produce a written determination showing that the labor expenses were necessary for the production, improvement, or preservation of low- and moderate-income housing as required by Health and Safety Code section 33334.3(d).

If the auditor had performed audit procedure 18 correctly, as directed in the firm's audit program, he/she should have noted and tested the allowability of the salaries and administrative expenses and other

unallowable or questionable charges made to the Low or Moderate Income Housing Fund. As a result, the city has been improperly charging administrative expenditures, including salaries and other questionable costs, to the Low and Moderate Income Housing Fund, thereby reducing the funds available for the program. In addition, the State cannot rely on the firm's conclusion that Bell Community Redevelopment Agency had no instances of noncompliance or other matters that should be reported.

Recommendation

The firm should:

- Comply with the RDA Audit Guide and its own audit program when testing for allowable expenditures.

- Test expenditures throughout the audit period so that its audit results can be relied upon.

Firm's Response

Our team has developed a California Supplement audit guide that was documented in the audit workpapers at workpaper R-O. This audit guide included consideration for documentation of more than 80 steps that addressed all 28 audit program areas contained in the Guidelines for Compliance of California Redevelopment Agencies that were issued by the California State Controller.

Of the more than 80 steps for which we obtained audit evidence, the SCO has identified the following areas of concern:

- The State Controller's draft report concluded that our workpapers did not contain documentation that the planning and administrative expenditures were necessary for the production improvement or preservation of low and moderate income housing. We disagree with the SCO conclusion. Our workpapers contained evidence of our examination of the trial balance of the Low and Moderate Income Housing Fund. This review indicated that planning and administrative expenditures of the Low and Moderate Income Housing Fund were not material. Nevertheless, testing was performed and our testing of certain charges to the fund indicated that such charges were for the improvement and preservation of low and moderate income housing. The nature and extent of audit testing is a matter of professional judgment. Our consideration of such testing in this case reflected a reasonable application of professional judgment.

- The State Controller's draft report suggested that trial balances for Fund 22 (low-mod Fund) for the year ended June 30, 2009 which were reviewed by the Audit Engagement Team for the entire year and documented on the trial balances included total expenses for the year audited (including salaries, fringe benefits, supplies and court administrative fee and other minor charges) of $161,313 for the entire year. Our audit sampling reviewed the documentation of $14,863 as stated by the SCO (13.16% of expenditures incurred through March 2009 and 9.2% of expenditures incurred for the entire fiscal year). Our review of the trial balance of the Low and Moderate Income Housing Fund indicated that the dollar amount of salaries charged to the fund was not unreasonable in view of the level of effort typically demanded by such funds. Approximately 10% of the salaries of certain personnel were

charged to the Low and Moderate Income Housing Fund. The majority of the planning and administrative expenses subject to the written determination requirement of the Low and Moderate Income Housing Fund pertained to the minimal amount of salaries charged to the fund. Although not material, we concur that our audit workpapers did not include retention of a client-prepared written determination as to the basis for the specific salaries that were charged to this fund.

- The county administrative fee represents an area of legal uncertainty with respect to applicability to all funds that receive an allocation of property taxes for the Agency. In the absence of a clear statement as to this issue in the Health and Safety Code, it is not uncommon, in our experience, for agencies to reasonably allocate the county's administrative fee to all funds that receive the benefit of the county's administration of property taxes. This is not an unreasonable position of agencies that take that view and a legal determination as to this would be outside the purview of a financial statement audit.
- The other charges mentioned in the State Controller's draft report were clearly immaterial (cell phone charges, etc.) and would not warrant additional testing, in our opinion.

We did not extend the testing performed during the interim stage of our audit because our review of trial balances obtained at year end indicated that there was not significant new activity incurred after our interim testing to warrant an extension of such testing. This review consisted of a comparison of the activities (and their magnitude) that existed during our interim testing (March 26, 2009) and year end June 30, 2009. We concur that our documentation of this consideration should have been better documented in the workpapers.

In summary, of the more than 80 audit steps for compliance conducted by our Firm, we believe that the following should be the SCO conclusion:

- The Firm did not obtain a client-determined analysis to support the allocation of administrative salaries that were made to the Low and Moderate Income Housing Fund.

The foregoing Redevelopment Agency findings constitute an immaterial instance of noncompliance on the part of the Agency and an immaterial departure in documentation standards with respect to our documentation of procedures required to be performed.

SCO's Comment

According to GAGAS 4.19, the auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand:

a. The nature, timing, and extent of auditing procedures performed to comply with GAGAS and other applicable standards and requirements;

b. The results of the audit procedures performed and the audit evidence obtained;

c. The conclusions reached on significant matters; . . .

In addition to its noncompliance with audit standards, the firm did not comply with section 5097 of the California Business and Professions Code as follows:

> (a) Audit documentation shall be a licensee's records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.
>
> (b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.
>
> (c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

The examination of the trial balance for the Low- and Moderate-Income Housing Fund would not necessarily determine the agency's compliance with low- and moderate-income housing fund requirements. The firm's comment that planning and administrative expenditures were not material to the financial statements has no bearing on testing and reporting on compliance. Although the expenditure amounts may be considered immaterial for the purpose of opining on the financial statements, this immateriality does not absolve the firm of the responsibility for testing the Bell Community Redevelopment Agency's compliance with RDA requirements.

The firm states that the county administrative fees represent an area of legal uncertainty with respect to the applicability of all funds that receive an allocation of property taxes. Our finding is not about the legality of the county administrative fee. Our finding clearly states that the firm did not adhere to the RDA Audit Guide and its own audit program in reviewing expenditures, such as planning and administrative expenses and overhead, etc.

As previously stated, even if the expenditure amounts for other charges (cell phone charges, etc.) were considered immaterial, materiality should not be considered a factor when determining compliance.

Our finding and recommendation remain unchanged.

Appendix 1—
Firm's November 11, 2010
Response to Draft Review Report

Mayer Hoffman McCann P.C.
An Independent CPA Firm

2301 Dupont Drive, Suite 200
Irvine, California 92612
949-474-2020 ph
949-263-5520 fx
www.mhm-pc.com

November 11, 2010

Federal Express - Return Receipt Requested

Jeffrey V. Brownfield
Chief, Division of Audits
California State Controller's Office
3301 C. Street, Suite 700
Sacramento, CA 95816

Dear Mr. Brownfield:

We appreciate the opportunity to provide our response to the draft report of the California State Controller's Office (SCO) on the inspection of Mayer Hoffman McCann P.C.'s (MHM or the Firm) audit workpapers for the City of Bell, California for the year ended June 30, 2009. As a member of the AICPA's Governmental Audit Quality Center, MHM is committed to the highest quality throughout our practice and we consider external inspections as an important component of improvement to our practice. In light of the value and importance we place on the inspection process, we have cooperated with the SCO by quickly and completely responding to every request for information the SCO has made.

SCOPE OF REVIEW

The August 3, 2010 letter from the State Controller's Office describing the scope and purpose of the quality control review of MHM's audit workpapers for the City of Bell, California for the year ended June 30, 2009 stated the following:

"We will hold an exit conference after fieldwork is completed; however, we will keep the firm informed of any issues or concerns that may arise during our review. A draft report will be issued when the review is completed. The report will reflect one of four conclusions:

- *The audit was performed in accordance with applicable standards and requirements for financial audits and compliance audits.*
- *The audit was performed in accordance with the majority of applicable standards and requirements for financial and compliance audits.*
- *The audit was performed in accordance with some elements of applicable standards and requirements for financial and compliance audits; however, the majority of auditing standards and requirements were not met.*
- *The audit was not performed in accordance with applicable standards and requirements for financial and compliance audits."*

DISAGREEMENT WITH SCO DRAFT CONCLUSION

We understand that the professional judgments of reasonable and highly competent professionals may differ. Accordingly, we respectfully disagree with the draft conclusion expressed in the draft report dated October 25, 2010 that "...the majority of auditing standards for fieldwork and OMB Circular A-133 requirements were not met."

We acknowledge there are areas for improvement that were identified in the SCO inspection. As previously noted, MHM considers the inspection process an integral component of our continuous improvement. We have carefully evaluated each of the concerns raised by the SCO and shared them with the engagement team, our city and municipal government audit leadership and Firm leadership. We also will use these results as we update our policies, and develop additional guidance for the Firm.

However, the conclusion that MHM has reached based our review of the SCO draft report and our audit working papers is that -

- **MHM's audit was performed in accordance with the majority of applicable standards and requirements for financial and compliance audits.**

Our response to the SCO will explain the basis for our conclusion, and why the SCO draft conclusion should be revised.

REQUEST FOR EXIT CONFERENCE

We believe it is important for the public that both the SCO and MHM serve to have accurate and objective reporting. We noted that in the SCO's report dated September 22, 2010 on Administrative and Internal Accounting Controls of the City of Bell, the SCO stated on page 2 that the SCO reviewed the independent auditor's working papers for the audit of the city's financial statements for Fiscal Year (FY) 2007-08 and FY 2008-09. While the SCO requested and MHM provided the audit working papers for FY 2008-09 for review, the SCO's report is inaccurate because the SCO did not have access to those FY 2007-08 working papers to perform a review of those working papers. To avoid further inaccuracies in the reporting to the public on matters impacting MHM's audit practice, MHM believes it is important to meet in person to review the SCO's draft and our response.

We respectfully request that the exit conference committed to by the SCO in their letter dated August 3, 2010 be held.

We have been reviewing the procedures we performed to reach a conclusion if there were any additional actions by the Firm necessary under AU 390, *Consideration of Omitted Procedures after the Report Date* and AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.* To reach the appropriate conclusions on these matters, we believe an exit conference with the SCO would be appropriate to determine if information has come to the SCO's attention during the performance of its Special Investigation that was not made available to us during the course of conducting our audit that would have a direct and material impact on the financial statements we reported on. At this date, we are not aware of any material misstatements in the financial statements for the year ended June 30, 2009 that we opined on.

OUR FIRM'S COMMENTS ON SPECIFIC DRAFT FINDINGS

Finding #1 – Should be deleted in its entirety and a new finding should be drafted to reflect that the Firm had minor instances of documentation deficiencies.

Finding #2 – This finding should be deleted except for a minor deficiency in documenting our evaluation of the City Charter and our rationale of significant provisions (or the lack thereof) in the Charter.

Finding #3 – This finding should be deleted in its entirety.

Finding #4 – This finding should be deleted in its entirety.

Finding #5 – This finding should be deleted in its entirety.

Finding #6 – This finding should be redrafted to indicate that deficiencies noted in the audit of Federal Programs contained minor documentation issues.

Finding #7 – This finding should be deleted in its entirety.

Finding #8 – This finding should be deleted in its entirety.

Finding #9 – This finding should be redrafted to indicate that the Firm did not have sufficient evidence of the Agencies' written documentation that planning and administrative expenditures were necessary for the production or improvement of low and moderate housing and that the Firm had other minor documentation issues in its documentation of compliance of more than 80 compliance steps in the SCO Audit Guide.

Finally, we believe the events in the City of Bell are very unfortunate for its hard working taxpayers. We will continue to cooperate with all parties in the regulatory and law enforcement agencies.

Mayer Hoffman McCann P.C.

MAYER HOFFMAN McCANN P.C.

MAH/kl
Attachments

1. City of Bell Fraud Prevention Policy
2. Entity and Activities Controls – City of Bell
3. Sopp Chevrolet Transaction Loan
4. Subsequent Events Emails
5. Subsequent Event Email $35,000,000 Series 2007 Issue
6. Subsequent Event Email – Best, Best & Krieger
7. Fraud Risk Communication with Bell City Council - April 8, 2009
8. Communication with Bell City Council Pertaining to Fraud Risks and Other Matters on December 18, 2009
9. City of Bell Management Representation Letter
10. John Chiang's Letter of Understanding dated August 3, 2010 regarding City of Bell Quality Control Review

I. EXECUTIVE SUMMARY OF RESPONSE

As described in greater detail below, our City of Bell workpapers demonstrated that we met the standard of care with respect to audit documentation for a financial statement audit.

Our engagement was planned and performed to obtain reasonable assurance about whether the financial statements were free of material misstatement. Our audit was conducted in accordance with Generally Accepted Government Auditing Standards and the results of the tests performed and evidence obtained indicated that the financial statements of the City of Bell were not materially misstated.

The draft report issued by the State Controller's Office (SCO) stated that our audit of the financial statements of the City of Bell for the year ended June 30, 2009 did not meet the auditing standards for field work. The auditing standards for field work are set forth in the codification of auditing standards at AU Section 150.02. Those standards are as follows:

1. The auditor must adequately plan the work and must properly supervise any assistants.
2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.
3. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Our workpapers clearly demonstrate that

1. We adequately planned our audit work and properly supervised our personnel. Our workpapers document our extensive planning considerations. All workpapers contain evidence of review by members of the engagement team that have significant experience in performing local government audits. The Senior Auditor assigned to the engagement has over 5 years of local government auditing experience. The Senior Engagement Manager and Engagement Shareholder assigned to the engagement have over 22 years of experience and 35 years of experience in performing local government audits, respectively.
2. We obtained a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. Our workpapers contain extensive documentation of our assessment of the risk of material misstatement and our understanding of the internal controls.
3. We obtained sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. As described in greater detail below, appropriate audit conclusions were reached based upon auditing procedures performed and evidence obtained.

The audit process is not designed to detect collusion, nor is the audit process in a position to measure the integrity of management or elected officials. The evidence examined during our financial statement audit of the City of Bell for the year ended June 30, 2009 did not indicate a heightened risk of management override of internal controls. With the exception of certain relatively minor issues relating to workpaper documentation, our auditing procedures conformed to auditing standards and properly supported an opinion of reasonable assurance that the financial statements were not materially misstated.

With respect to the issues raised in each of the nine findings in the SCO's draft report, our workpapers demonstrate that we met the requirements of the auditing standards, as summarized in the summary below (and as indicated in our detailed response provided for each finding):

(1) **Audit Documentation And Audit Evidence Were Not Deficient**

Analytical Procedures and Materiality—Our workpapers demonstrate that we did not rely solely upon analytical procedures to evaluate the risk of material misstatement for relevant financial statement assertions. Tests of controls and other substantive procedures were performed for each of the areas identified in the SCO draft report with respect to this issue. Our materiality workpapers conformed to all applicable standards and included qualitative considerations and government-specific considerations, as required by Government Auditing Standards.

Capital assets—We did not rely solely on analytical procedures with respect to our consideration of material misstatement for capital assets. We obtained supporting records for capital asset additions and tested significant additions. We also reviewed city council minutes, made inquiries of management, and obtained verbal and written representations from management with respect to any potential impairment of capital assets.

Payroll—Our workpapers demonstrate that we tested key controls associated with payroll and performed cut-off tests and analytical procedures. Our audit work in the payroll area was entirely consistent with the standard of care for a financial statement audit.

Consideration of Contracts, Grant Agreements, Laws and Regulations—Our workpapers contain extensive documentation demonstrating our consideration of the effect of compliance associated with contracts, grant agreements, laws and regulations that might have a direct and material effect on the determination of financial statement amounts. These workpapers include extensive testing of federal program compliance, compliance with redevelopment law, Gann limit compliance, government code compliance with respect to investments, debt compliance testing, and an extensive permanent file documentation of other grants, contracts, and agreements.

(2) **Consideration Of The Risk Of Fraud In A Financial Statement Audit Was Not Deficient**

Our consideration of the risk of fraud was thoroughly documented in our workpapers.

(3) **Evaluation And Documentation Of Going Concern Issues Was Not Deficient**

Our workpapers clearly document that we did not have substantial doubt concerning the ability of the City to pay its obligations as they become due for the twelve month time frame contemplated by the auditing standards for the year ended June 30, 2009.

(4) **Documentation And Evaluation Of Subsequent Events Was Not Deficient**

Our workpapers demonstrate that we performed all of the subsequent event procedures required by the auditing standards.

(5) **Identification Of Litigation Claims And Assessments Was Not Deficient**

Our workpapers demonstrate that we performed all required procedures to identify litigation, claims, and assessments, including all required inquiries, a review of city council minutes, confirmation with the City Attorney, and a follow up contact with the City Attorney at the time of the release of the financial statements.

(6) **Testing Of Federal Program Compliance Requirements Was Not Deficient**

Our workpapers demonstrate that we tested all applicable provisions of compliance testing required of the City's major federal programs.

(7) **Evaluation Of Internal Controls Over Major Federal Programs Was Not Deficient**

Our workpapers demonstrate that we documented and tested key controls that were applicable to major federal programs.

(8) **Audit Documentation Regarding The Redevelopment Agency Was Not Deficient**

Our workpapers demonstrate that we fully documented with all of the areas addressed in the SCO report for the redevelopment agency issues that were relevant to our audit for the year ended June 30, 2009.

(9) **Testing Of Compliance With The Redevelopment Agency Audit Guide Was Not Deficient**

Our workpapers demonstrate the sufficiency of our testing of the activities of the Low and Moderate Income Housing Fund and our documentation of compliance requirements in the SCO Audit Guide.

II. BACKGROUND OF REVIEW

Some three months after commencing its quality control review of MHM's audit of the June 30, 2009 financial statements of the City of Bell, the SCO issued its draft report on October 25, 2010.

The report is 32 pages long and contains some 70 findings. And yet, the SCO gave MHM only 15 days to prepare its written response.

On the date MHM received the report, counsel for MHM requested that the SCO extend MHM's time to respond. The SCO had previously been advised that MHM's counsel was out of the country until November 16, 2010. MHM was advised that it must make that request to the Chief of the SCO's Financial Audits Bureau.

On October 29, 2010, counsel for MHM requested that the Chief extend MHM's time for a written response, and he also requested a meeting between the SCO and MHM auditors. The basis for the request was the breadth of the draft report, certain inaccuracies and misunderstandings in it, and the unavailability of MHM's counsel. MHM's counsel also noted in that call that the comment on page 3 of the draft report, suggesting that communication with MHM's attorney somehow prevented the SCO from, "discussing" the review results with the firm," was incorrect. In fact, on several occasions during the SCO's review, counsel inquired whether the SCO had questions or otherwise wished to talk or meet the MHM personnel directly, and was told that the SCO was satisfied with the line of communication through counsel. As a result of this apparent miscommunication, it was made clear in the October 29th call that the MHM auditors were not only available, but were eager to meet with the SCO to discuss the draft report and the firm's response to it. MHM was told by the SCO's Chief auditor that she would not be available until after Thanksgiving for a meeting, and would discuss with her supervisor MHM's request.

On November 1, 2010, the SCO responded to the request by giving MHM a three day extension to provide its written response and declining to advise whether or not the SCO would meet with MHM until after it received MHM's response.

On November 2, 2010, the SCO Chief auditor left a voicemail for MHM's counsel asking for acknowledgement of receipt of the November 1st email. Counsel returned the call, acknowledged the email, and asked that the SCO chief auditor call him to discuss the extremely short extension and the refusal to meet. Counsel for MHM called the SCO again to discuss the same issues. Neither call was returned.

MHM has quickly and completely responded to every request for information the SCO has made. The SCO has never indicated that MHM has been anything other than completely cooperative in the quality control review process. MHM is therefore very concerned that after it has taken some three months to issue its draft report containing extensive findings, the SCO has limited MHM's time to respond to a matter of days, and unilaterally set the response date for a time it knows MHM's counsel is out of the country, and has refused a face-to-face meeting to attempt to ensure clarity, and an accurate and fair outcome of this extensive process. Further, the engagement letter from the SCO to MHM provides for an exit conference meeting.

That concern has only been heightened by comments in the press by SCO officials concerning MHM and the audit under review before the draft report was even issued, which suggested that at least certain SCO staff had come to judgments concerning these matters without the completion of the review or all of the facts and evidence before them.

For all of these reasons, MHM strongly protests the SCO's positions and the limitations it has placed on MHM with respect to this response. MHM has done its best to deal with and provide this response in the face of these limitations, but it is neither reasonable, nor frankly possible to respond in a matter of days to an extensive report that it took the SCO months to produce. Furthermore, it is likely that the issues would be clarified and reduced were the SCO to agree to a meeting.

III. RESPONSES TO STATE CONTROLLER'S FINDINGS

(1) AUDIT DOCUMENTATION AND AUDIT EVIDENCE WERE NOT DEFICIENT

ANALYTICAL PROCEDURES

The draft state controller's report was incorrect in suggesting that we did not follow Generally Accepted Government Auditing Standards (GAGAS) and U.S. generally accepted auditing standards with respect to the establishment of planning materiality and the use of analytical procedures.

With respect to planning materiality, the state controller's report cited GAGAS 4.26 which indicates that additional considerations may apply to GAGAS financial audits of government entities.

It should be noted that the citation quoted in the state controller's report (GAGAS 4.26) uses the permissive sense ("may find it appropriate to use lower..."), rather than the prescriptive sense. This means that after such consideration, the auditor may or may not find it appropriate to lower his or her planned materiality threshold based upon the relevant facts and circumstances known to the auditor during the risk assessment. The issues relevant to an adjustment of planning materiality are the same issues that were documented in 3-5B with respect to the entity and activity level internal control environment of the City. When developing our planning

materiality, the issues at 3-5B were known to the audit team and considered by our firm as to the appropriateness of adjusting our planned materiality thresholds. Our documentation in this workpaper indicates that we assessed during the planning stage of our audit that there were no unusual issues of fraud risk, political sensitivity, or legal or regulatory compliance that was known to the engagement team to warrant a change in our planned materiality thresholds. In fact, at the time that the 2009 audit was performed, there was no evidence of the issues that later became disclosed in 2010. Our considerations were documented at workpaper 3-5B and did not warrant the need to adjust our planned materiality thresholds. This is an issue of professional judgment that was properly considered and determined by our firm based on the facts and circumstances available at that time and reasonable conclusions were reached with respect to this issue.

MHM, in fact, considers the uniqueness of the government environment to determine materiality on its governmental audits. On governmental entities, MHM determines materiality on an opinion unit basis which is different than the process used to determine materiality for non-GAGAS or for-profit entities. Determining materiality by opinion unit forces lower levels of materiality for governmental audits as specified by GAGAS 4.26.

The draft state controller's report suggested that we did not consider qualitative aspects when assessing materiality. We disagree with SCO conclusion regarding consideration of qualitative aspects considered in assessing materiality for the City of Bell audit.

Our workpaper documentation at workpaper 3-11 documents clearly our consideration of qualitative aspects in assessing our planning materiality. In workpaper 3-11, we documented our consideration, as follows:

> In determining planning materiality, auditors can consider whether qualitative factors may distort quantitative measures. If this is the case, auditors may choose to eliminate certain large dollar items from the calculation and set separate planning materiality levels for the excluded items and for the remaining items.

The decision was made by our audit team that we would intentionally and deliberately exclude capital assets from our consideration of planning materiality because the large dollar balances of capital assets might distort our consideration of planning materiality with respect to the City's audit.

It should be noted that the threshold use for selection of balances to be subjected to our analytical procedures was 2/10 of one percent of the total assets of the City.

The state controller's draft report also suggested that the firm relied on the same analytical procedures to conclude that the financial statements were fairly stated instead of performing other substantive tests. The standards and facts indicate that the SCO's suggestion is inaccurate.

AU 329.22 states:

> When an analytical procedure is used as the principle substantive test of a significant statement assertion, the auditor should document all of the following:
>
> a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed and factors considered in its development [this was documented at workpaper 3-10]
> b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts [this was documented at workpaper 3-10]
> c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedures and the results of such additional procedures [no unexpected differences were identified]

As discussed further below, we did not rely solely on analytical procedures with respect to the relevant financial statement assertions for Accounts Receivable, Capital Assets, and Payroll (existence and occurrence, valuation or allocation, presentation or disclosure and completeness), as suggested by the draft state controller's report. In fact, for each of those areas, a number of additional procedures were performed.

For example, for accounts receivable, assertions of existence, valuation, and presentation were addressed as follows: Per workpaper D-1, using auditor's judgment, we vouched certain individually significant items that were reflected in receivable balances to evidence of subsequent collection. For the disclosure assertion, we utilized our firm's disclosure checklist. Analytical procedures were only relied upon for the completeness assertion. The responses to our analytical procedures did not indicate a heightened risk of material misstatement with respect to accrued revenues that warranted, much less required, further testwork.

For Capital Assets and Payroll, see the discussion below of the audit procedures in addition to the analytics that were performed and addressed material assertions relevant to those audit areas.

It should be noted that professional standards do not require the auditor to test all assertions relative to an account balance or transaction class. The standards require the auditor to assess the risk of misstatement inherent in each of the relative assertions and design procedures accordingly, but there is no requirement to test all assertions related to each account balance or to test them to the same level of confidence.

CASH AND INVESTMENTS

We disagree with the SCO conclusion that our audit testing for cash and investments was inadequate due to a very minor ($4,317) variance that existed in cash and investments between our audit support and the recorded cash and investments by fund that was not pursued for further investigation due to its extreme immateriality. We disagree with the SCO conclusion that our documentation was inadequate pertaining to the disposition of this small variance. Based upon the extensive audit tests completed in cash and investments, meeting the existence, valuation and completeness assertions, we documented that "the difference is relatively insignificant and MHM passed on further testwork". This variance was less than one-tenth of 1% of the City's total cash and investment balances at June 30, 2009 of $47,872,843. The City's total assets at June 30, 2009 were $193,052,545. It is inaccurate to suggest as the draft SCO report does that the scope of an audit requires the investigation and disposition of every unreconciled difference identified in the City's books and records, especially when that amount is clearly inconsequential and immaterial to the financial statements that we were engaged to audit.

ACCOUNTS RECEIVABLE

We disagree with the SCO conclusion that our audit documentation was inadequate with respect to a receivable in the amount of $300,000. This transaction was made in the fiscal year ended June 30, 2008 and we reviewed the underlying audit documentation in that fiscal year (See Attachment #3). Our audit tests documented that, in the general fund, this $300,000 asset was offset by an equal amount in deferred revenue (a liability), similar to a rehabilitation loan. Since this loan receivable was fully off-set by deferred revenue in an equal amount recorded in the City's liabilities, there was no risk of misstatement with respect to the fund balance of the general fund. Due to the dollar amounts involved, the recent nature of the transaction, this loan's effect on fund balance of the fund, and in consideration of the documentation examined at the time of issuance, we believe that sufficient audit evidence was obtained to support all relevant financial statement assertions for this item.

As noted in the State Controller's Draft Report, the financial statements of the City presented accounts receivable reported in the non-major funds at a dollar amount of $41,018. The analysis provided by the client addressed detailed support for $20,446 of the $41,018 balance reported in the financial statements. This difference of $20,572 was not material. As previously stated, it is inaccurate to suggest that the scope of an audit requires the investigation and disposition of every unreconciled difference identified in the City's books and records, especially when that amount is clearly inconsequential and immaterial to the financial statements that we were engaged to audit.

CAPITAL ASSETS

We disagree with the SCO conclusion that inadequate substantive audit testing was performed in capital assets. In workpaper 3-7A, we clearly reviewed as a part of our journal entry analysis and review of documentation for the building purchased by the Community Redevelopment Agency for the Deeds of Trust for 6415/6425 and 6501 Atlantic Blvd. These audit procedures were performed in addition to our analytical review of capital assets. Our workpapers clearly demonstrate that the assertion of existence, ownership, rights and valuation were tested. The

above procedures documented in our workpapers demonstrated that the Capital Asset was acquired on May 21, 2009. The City did not inform the auditors that an appraisal had been performed in conjunction with this transaction. For the purposes of preparing local government financial statements, an asset's value is determined by the cost incurred (cash paid plus indebtedness incurred) to obtain the asset (otherwise known as the "historical cost basis"). The appraised value of a property is irrelevant for purposes of determining the initial amount of the asset to record (i.e., the historical cost incurred by the City to acquire the property) for the City acquired asset. Our testing for this transaction was performed during our routine testing of journal entries that were reflected in the City's accounting system. One of the journal entries tested in that phase of our field work represented the recording of the proceeds of debt that was incurred to acquire this property. As a part of our journal entry testing, we reviewed this entry and related support. $200,000 of cash was also contributed toward this property transaction in a separate entry recorded in the accounting system of the City in the previous fiscal year. The entry for the $200,000 cash portion of the purchase was not selected during our journal entry testing due to the immateriality of the entry (less than 1% of total City expenditures) and that it occurred in the previous fiscal year. The documentation for the recorded cost of these buildings was $4,600,000. This capital addition that was tested during our journal entry testing also represented 36% of the capital additions of the City for the year. It should be noted that for assets, the significant audit risk is the risk of overstatement, not understatement, and as such additional procedures to test the completeness assertion were not considered necessary given the nature and extent of the other assertions tested and procedures performed.

We disagree with the SCO conclusion that inadequate auditing was done on capital asset impairments. Our audit program conclusion of "no impairments detected" was documented through the auditor performing tests of capital assets and inquiry of client personnel. The City's Senior Accountant interacted with the auditors and provided that response for the documentation. Further, in our written representation letter at workpaper 4-9, 2 signed by the former CAO (Robert Rizzo) and the Director of Administrative Services (DAS) (Lourdes Garcia) (Attachment No. 9) the City represented that it has no plans that would materially affect the carrying value or classification of assets. Additionally, in our subsequent events audit documentation, our senior auditor inquired and documented on December 19, 2009, with the City's Senior Accountant and Director of Administrative Services whether there were any events that occurred that caused a decline in the value of any assets. While the SCO believes that our inquiries, review of minutes and client representations should have disclosed a possible impairment, they did not, because of responses and documentation provided during our audit process. Moreover, our minutes review at workpaper 4-2A disclosed that the minutes did not discuss any legal invalidation of the lease between the City and the Railway and Environmental issues that would have surfaced a potential impairment issue. Further, the attorney letter response from the City Attorney, Edward Lee of Best, Best & Krieger to auditor inquiries regarding potential legal issues (at workpaper 4-3B), dated October 8, 2009 and updated on December 22, 2009 (Attachment #6) did not have any mention of this issue or the court order in which the SCO's draft report refers.

Paragraph 8 of GASB Statement No. 42 indicates:

> 8. The events or changes in circumstances affecting a capital asset that may indicate impairment are prominent—that is, conspicuous or known to the government. Absent any such events or changes in circumstances, governments are not required to perform additional procedures to identify potential impairment of capital assets beyond those already performed as part of their normal operations. The events or circumstances that may indicate impairment generally are expected to have prompted discussion by the governing board, management, or the media.

Based upon the standard of reporting impairments as defined above, our inquiries with both management and legal counsel and review of the minutes were appropriate and reasonable measures to be taken during the audit process to identify "prominent impairment that was conspicuous and known to the government." The fact that the City, its attorney and its minutes did not disclose these issues indicate that it was neither prominent nor conspicuous. Therefore, there was no deficiency in the audit process with respect to this issue.

The draft State Controller's Report cited AU Section 326.35 which states that "inquiry alone ordinarily does not provide sufficient appropriate audit evidence" [emphasis added]. The use of the word "ordinarily" implies that there are some circumstances when inquiry alone would be appropriate.

The circumstances associated with asset impairment ("prominent", "conspicuous", "known to the government", "not required to perform additional procedures to identify potential impairment", etc.) represent an area of audit responsibility for which inquiry (in combination with a review of minutes) are, in fact, reasonable and appropriate auditor responses to the risk of material misstatement potentially applicable to this area of financial reporting.

Moreover, paragraph 18 of GASB Statement No. 42 specifies that an asset's recorded value should not be written down unless the impairment is permanent:

> 18. Generally, an impairment should be considered permanent. In certain circumstances involving capital assets impaired through enactment or approval of laws or regulations or other changes in environmental factors, change in technology or obsolescence, change in manner or duration of use, or construction stoppage; however, evidence may be available to demonstrate that the impairment will be temporary. In such circumstances, the capital asset should not be written down.

A judge blocking an extension of an existing lease due to the lack of an environmental review would not necessarily create a permanent impairment in the value of an asset. The subsequent completion and submission of such an environmental review could have remedied the issue and made the impairment only temporary, and therefore not recordable. GASB Statement No. 42 paragraph 9 (b) provides a potential example of a similar situation where an impairment may be other than permanent if modifications can be met. In either event, our inquiries and procedures concerning this issue, including receipt of written representations, review of minutes and inquiring of legal counsel were appropriate, prudent and consistent with the standards governing

auditing the issue of asset impairment. There was no deficiency in the audit process with respect to this issue.

We further disagree with the SCO conclusion that audit documentation was not adequate to understand and validate controls over the completeness of capital assets. We obtained evidence concerning the completeness of capital asset additions by evaluating and testing the internal controls surrounding that process (STC6-A). This assessment of internal control did not indicate the need to perform more extensive substantive procedures, such as an exhaustive search of the accounting records for capital asset additions that were not recorded. The controls over changes in capital assets were reviewed and documented at the internal control workpaper STC6-A. The City's Senior Accountant (who has previous CPA Firm auditing experience) was the preparer of the changes to capital assets and the Director of Administrative Services (DAS) reviewed the capital asset activity to insure all capital assets were appropriately reflected. The auditors obtained and reviewed the client journal entries to record additions and deletions to fixed assets reviewing that the proper key internal controls were in place over capital asset accounting.

During the year under audit, approximately $559,000 of deletions were made to capital assets. More than 90% of the deletions were infrastructure and improvements being replaced (streets, traffic signals etc...) (See workpaper E-1). These deletions did not involve the disposition of assets acquired with federal funding to which federal disposition requirements would apply. We believe the foregoing facts clearly demonstrate that controls over the completeness of capital assets were very satisfactory.

PAYROLL

We disagree with the SCO conclusion that the auditors used only analytical tests in the payroll area. Analytical tests were only one test used in our audit procedures concerning payroll. We also disagree with the SCO conclusion that payroll charged to funds other than the general fund was not subjected to the analytical tests. All funds were included in the analytical tests at workpaper 3-10 (not just the General Fund, as suggested by the draft SCO report), for fluctuations of revenues and expenses for the scope established in our test, including solid waste, recycling authority, Surplus Property Authority, Public Housing Authority and Community Housing Authority Funds. The expenditure accounts subjected to our analytical review procedures included all funds of the City. All expenditure accounts recorded in the accounting system of the City that contained a balance greater than $400,000 were analyzed as a part of our analytical review procedures (not just the General Fund, as suggested by the draft SCO report).

In addition to analytical tests that covered payroll, we also documented the process associated with payroll processing at the City of Bell at file STC4-A and generally control risk is assessed as low with respect to material misstatements associated with payroll transactions.

Our documentation of the payroll system included the following aspects of the payroll process:

- Authorization to add employees, delete employees and authorizations required on Personnel Action Forms (PAF's)
- Access to Payroll Master File

- Timesheet Reporting and Requirements
- Timesheet Approvals
- Direct Deposit and Payroll Reconciliation
- Controls over the Preparation and Approval of Payroll.
- Controls of the Payroll Account, Payroll Tax return process.

After documentation of key controls in payroll, these key controls were tested through observation and inspection as documented at workpaper STC4-C. Our auditors observed the process of approvals and tested them in accordance with AICPA Professional Standards. The population for which we did our test of controls included all employees' paychecks including the Former CAO. The foregoing was in addition to the analytical tests performed in our audit.

These tests of payroll controls, in consideration of the relatively low risk of material misstatement associated with payroll and the performance of other substantive procedures (analytical review procedures, cut-off tests, etc.) were appropriate under the circumstances and reflected a reasonable application of professional judgment by the auditor. The SCO draft report indicated that the City Manager's salary "was not identified in the firm's analytical review for further investigation, as directed by the audit procedure" (page 8 of the draft SCO report). The reason the City Manager's salary "was not identified in the firm's analytical review for further investigation" was because his salary did not create a material variance warranting further investigation under the requirements of the analytical review process. Furthermore, it is not uncommon for a City Manager's salary to be allocated to various funds of the local government. Again, this was not an issue identified by our analytical review procedures as warranting further investigation.

In our payroll testing, the City Manager's salary was not singled out and specifically tested in the audit process because the focus of the audit process is on the risk of material misstatement and on legal issues that would have a direct and material effect on the determination of financial statement amounts.

We disagree with the SCO conclusion that there were deficiencies in the firm's consideration of risk of fraud in the financial statement audit. Specifically, we documented through observation and inquiry at workpaper 3-7 Fraud Risk Inquiries of the Director of Administrative Services and City's Senior Accountant. We also documented risks in the financial statement audit at workpaper 3-8. We also documented at workpaper 3-5c the management Anti-Fraud Programs and Controls. The entity and Activity Level Controls were thoroughly documented at workpaper 3-5B (Attachment 2).

We disagree with the SCO conclusion that our audit procedures did not meet generally accepted auditing standards with respect to employee advances. Our audit procedures did include a thorough review of the trial balances. There were no employee loans receivable or advances reflected as assets on any of the City's trial balances at June 30, 2009. Further, the accounts receivable summary provided by the City's Senior Accountant reflected no employee receivables in account #125. The foregoing results of the two reviews did not raise an issue of additional risk. Further, at workpaper STC2 B-1 we performed a test of disbursement transactions and

those disbursement tests did not disclose any disbursements to employees that were not properly documented and recorded nor did they indicate the existence of the unrecorded loans. As a result of these tests, we concluded that the controls were operating effectively. Furthermore, management's written representations signed by Robert Rizzo, Chief Administrative Officer, and Lourdes Garcia, Director of Administrative Services, indicated that the financial statements reflected the recording of all related party transactions, including loans and amounts receivable from or payable to related parties (see Attachment 9). Our properly conducted testing of cash disbursements did not identify any unrecorded employee loans. AU 110.02 indicates that the audit process provides "reasonable, but not absolute assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected." Our auditing procedures conformed to this standard.

The SCO conclusion is correct that our audit program did have a step to identify bonuses or other unusual compensation. As documented at J-0A, our audit staff performed inquires with Anna Montoya, Senior Accountant, who indicated that no material or large bonuses are given. That inquiry and response from the City's Senior Accountant and our other tests of key controls in payroll previously discussed were appropriate audit evidence. The draft SCO report indicated that the audit firm did not explicitly document discussion of the possibility of management bonuses in its brainstorming session. This is correct. The reason there was no explicit documentation of this discussion is that there was no history of paying such bonuses in the past (based upon the auditor's experience in performing audits of the City for prior fiscal years) and because this was an explicit step in our audit program that was known to be addressed in our firm's standard audit process. At the time of the brainstorming session, the audit team had no reason to identify this issue as an issue of risk unique to the Bell audit that required the performance of procedures beyond the procedures addressed in our audit program.

It should be noted that, in fact, inquiries concerning management bonuses were made during the audit process.

The draft SCO report suggests that "had the firm performed certain other substantive procedures such as reconciling payroll registers with payroll expenditures reported, or reviewing general ledger accounts for unusual activity, it should have noted that public funds were being advanced to city employees." It should be noted that these additional procedures suggested in the draft SCO report are inconsistent with predominant practice with respect to local government audits. The payroll audit program located at ALG-AP-10 in the Thomson publication entitled "PPC's Guide to Audits of Local Governments" indicates that the basic audit approach for payroll is analytical review procedures. The PPC publications are a widely used reference source for the practical application of local government audits.

The additional substantive procedures suggested in the SCO draft audit report are identified by PPC as additional procedures that should only be performed where the auditor's risk assessment supports a deviation from the normal approach to auditing payroll in a local government audit, which is limited to analytical review procedures. Our risk assessment for the June 30, 2009 Bell audit did not indicate the need to deviate from established practice with respect to the audit of

payroll in a local government audit (which are limited to tests of controls and use of analytical procedures).

The draft SCO report at page 9 indicated that "one payroll item tested as part of the analytical review met, but did not exceed the established materiality levels of $200,000 and 15%. However, because it did not exceed the established materiality levels, the auditor simply accepted the explanation from city management and performed no further work." In fact, our work in this area conformed to the requirements of AU 329.22 which requires that the auditor document "any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures". The explanation obtained from finance personnel was that "due to a decrease in overall general fund revenues in the current fiscal year, the City cut several recreation and sports programs offered to the community." We documented at workpaper 3-10 that this explanation was reasonable in light of current economic conditions and that, accordingly, no further testing needed to be performed. The variance was neither unexpected, nor was the explanation inconsistent with information known to the audit team concerning the economic environment in which local governments are operating. Corroboration of this known economic condition was clearly not warranted in this situation. It should be noted that the variance in question was a decline in salaries expense, rather than an increase in salaries expense. A material increase in compensation revealed by our analytical review procedures might have warranted substantiation due to the potential implied risks of fraud not present in a decline in salaries expense.

CONSIDERATION OF CONTRACTS, GRANT AGREEMENTS, LAWS AND REGULATIONS

We disagree with the SCO conclusion that our audit workpapers documentation did not consider compliance with laws and regulations that may have had a direct and material effect on the determination of financial statement amounts. We provided the SCO office with our permanent files supporting:

- All Important Agreements, Contract and Debt Provisions, including all Revenue Bond Agreements, Lease Obligations, Concession and other Income Agreements, Pension Plan Information, Joint Powers Authorities, Management Agreements, Important ordinances and resolutions, Notes, Developer Agreements and other important copies of accounting and reporting requirements.

- Our audit documentation demonstrates at workpaper C-1 that our audit tests were designed to test Investment Compliance in accordance with various sections of the California Government Code (Sections 53601 and 53646). These were identified as specific audit risk areas requiring documentation of compliance with the California Government Code.
- Our audit risk assessment also identified debt compliance as a risk area and specific audit tests were documented at workpaper C-6. Official statements in our permanent files were

also used to document our conclusion on consideration of compliance with important agreements.

- Our audit documentation and audit program together with an agreed-upon audit procedures report addressed Article XIII B of the State Constitution as an important law to test. Those audit procedures were documented at workpapers S-0, S-1, S-2, S-3 and 1-6.

- Extensive testing of laws and regulations pertaining to federal funding (workpapers SA 1-1.2 through SA LL-4) and redevelopment compliance (workpapers R-0 through S-3) were performed as a part of our audit of the City and Redevelopment Agency.

As stated above, there was extensive documentation in our audit workpapers that identified which laws and sections of the Government Code that we believed were important when designing our audit procedures. The fact that certain audit procedures were not signed off on the audit program until near the end of the audit was not indicative of when the audit work associated with the step was started, substantially performed, and resolved as to all pending items. The audit documentation in our planning section at workpaper 3-0 to 3-7 were dated in March, 2009 when the audit planning commenced. The audit process continued from March to December 2009 and audit documentation was prepared and reviewed throughout the audit process. The audit steps and documentation of the audit work were therefore completed before the audit report was issued. Therefore, we disagree with the SCO conclusion that consideration of the foregoing was not done during the planning process. Based upon the audit evidence in the working papers cited above, appropriate consideration was given to laws and regulations that were likely to have a direct and material impact on the determination of financial statement amounts.

(2) FIRM'S CONSIDERATION OF THE RISK OF FRAUD IN A FINANCIAL STATEMENT AUDIT WAS NOT DEFICIENT

We disagree with the SCO conclusion that there were deficiencies in the Firm's consideration of the risk of fraud in a financial statement audit as required by AU Section 316 of the AICPA Professional Standards. Specifically, our audit documentation did consider Antifraud Programs and Controls and it did not do so, as the SCO suggests, in some sort of "Pro-forma manner". Workpapers 3-5B through 3-5C documents that during the audit planning, extensive documentation was obtained from the DAS to document Entity and Activity Level Controls (Attachment #2). From all documentation received and from our observation of the environment, there was no perceived heightened risk of fraud. All documents obtained indicated that the City of Bell had programs and controls in place to prevent, deter and detect fraud. We were provided a copy of the City's Fraud Prevention Policy, dated July 1, 2008 (Attachment No. 1) which indicated that it was approved by the City Council. This document was drafted by the Finance Department (Principally DAS) and was approved by City Council. See attached Fraud Prevention Policy, dated July 1, 2008 (Attachment #1). This workpaper was previously provided to the SCO with our permanent file of documents at workpaper III-2,6. This document was reviewed by the Engagement Manager and Engagement Shareholder during the 2009 audit.

We disagree with the SCO conclusion that we did not comply with professional standards pertaining to which audit personnel should be involved in the documented discussions regarding the risk of material misstatement due to fraud. AICPA Professional Standards AU 316.17 states that "the discussion ordinarily should include the key members of the audit team". Our workpapers document that the Shareholder, Engagement Manager and Senior Field Auditor were the key members of the audit team and present during the discussion. Additionally, all work of associates who participated in the audit was reviewed by one or more key members of the audit team. Our workpapers document (at workpaper 3-5B) that there was no change in the entity-wide fraud controls from that of the previous year based upon evidence that is at workpaper 3-5B. Accordingly, the documentation of our engagement team discussion of fraud risk and misstatement risk that occurred during the planning phase of the 2009 audit took into account our prior experience and understanding of these controls and their impact on the audit. Had there been a change in controls that became known to a team member subsequent to that meeting, the team member identifying that change in controls would have initiated contact with other team members so that our engagement team discussion and conclusions could have been amended. The SCO conclusion is correct that the Auditors assessed the fraud risk as low. Our reliance on internal controls was based upon tests of key controls. These key controls were documented at the following workpaper locations:

- Revenue STC-1 series of workpapers
- Payroll STC-4 series of workpapers
- Bank Reconciliations STC-5 series of workpapers
- Capital Assets STC-6 series of workpapers
- Expenditures/Purchases – STC-2 series of workpapers
- Investment – STC-3 series of workpapers

The draft SCO report suggested that the documentation of our engagement team discussion contained only a preformed list of matters to discuss, with no added matters that were specifically addressed during the actual engagement team discussion for the City of Bell. This is incorrect. Our documentation of the engagement team discussion ("brainstorming session") at workpaper 3-6, specifically identified the following explicit matters that were not a part of the "preformed" items in the form used by the team to document the engagement team discussion, but were in fact added to the form as explicit documentation of actual matters discussed during this meeting:

1. Revenue Recognition.
2. Classification of Expenditures (In The Right Funds) – TOT (Test of Transactions)
3. Transfer to/from other Funds – Transfer of Restricted Funds to Non-Restricted Funds.

We further documented on the same form the actual procedures that were later performed to address the specific matters emphasized during the engagement team discussion.

Revenue Recognition.

MHM Tested Revenues/Receivables In Determining If The City Is Following A Proper And Adequate Revenue Recognition Policy As Per What Is Disclosed In Their Financial Statements. See D-Section.

Classification Of Expenditures (In The Right Funds) – TOT (Test of Transactions)

MHM Selected 25 Random Expenditures Incurring Between The Period Of 7/1/09 And 3/23/09. MHM Tested These Expenditures For Proper Fund Classification, Reasonableness And Other Criteria As Defined By The Testwork. See STC2-B.1.

Transfer To/From Other Funds – Transfer Of Restricted Funds To Non-Restricted Funds.

MHM Tested Transfers To/From Restricted Funds. MHM Tested The Transfers Out Of Restricted Funds. See I-Section.

As documented in the Summary of Significant Accounting policies, the City of Bell was a Charter City commencing January, 2006. Our testing of the City Charter was principally directed at City Treasurer and Finance duties that are referred to in Sections 705 and 706 of the Charter. We observed no other significant items in the Charter requiring attention. We concur that our documentation and rationale of significant charter considerations should have been included in our electronic files or permanent file. We also believed that the City of Bell Procedures Manual (in our Permanent File III-2, 4) was an important consideration of the risk of fraud in a financial statement audit. This document was utilized in our 2009 audit as a supplement to our documentation of fraud risks and internal controls and in the application of our key controls testing as we examined documentation during our testing of cash disbursements.

City Council compensation and the surety bond referred to in the City Charter are not matters that would have a direct and material effect on the determination of financial statement amounts. Further, we disagree with the SCO conclusion that had our documentation included an analysis

of significant Charter provisions, it would not have provided any guidance on whether tax increases were compliant with laws. The SCO in another report to the LA County Auditor-Controller as part of its earlier performance audit stated that on July 27, 2007, the City Council passed resolution 2007-42 that improperly increased the rate of Retirement Tax. The Charter of the City of Bell is very general in nature and did not provide the specificity to speak to the technical issues of legal compliance that were addressed in the State Controller's more expansive performance audit that addressed the legal and governance issues that were beyond the scope of a financial statement audit for local government entities.

The SCO report suggested that the CAO was the primary individual involved in executing internal controls of the City in 2009. However, as documented by our tests of key controls, in 2009, there were a number of personnel (not just the CAO) involved in the execution of key controls and transactional controls were sufficient to support our assessment of control risk for purposes of evaluating the risk of material misstatement. Furthermore, as documented in the City's internal controls, there was no evidence or indication that there was a heightened risk of management override.

As a further matter in our fraud risk assessment, our Firm communicated in writing with the Bell City Council twice during the audit on April 8, 2009 (Attachment #7) and again on December 18, 2009 (Attachment #8). The City Council was allowed direct access to the Engagement Shareholder via phone or email on matters relating to any matters of employee fraud or any other instances of improper practices of the City of Bell (Workpapers I-5 and I-5, 2). We documented (on 1-5.2) that in response to our inquiries, no councilmembers identified known or suspected concerns regarding fraud.

(3) EVALUATION AND DOCUMENTATION OF GOING CONCERN ISSUES WAS NOT DEFICIENT

We disagree with the SCO conclusion that we did not properly evaluate and document the City of Bell's ability to continue as a going concern for a reasonable period to time, as required under Generally Accepted Auditing Standards (GAAS).

With respect to the auditor's responsibility regarding going concern issues, AU 341.02 states:

> The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.

As a part of our subsequent events review, we obtained documentation from the City's Finance Department supporting the First Amendment to the $35,000,000 Bell Public Financing Authority Taxable Leased Revenue Bonds, Series 2007 Financial Facility Agreement (Attachment #5). This documentation was obtained as a part of our subsequent events review and referred to in the audit program at workpaper 4-5. Our understanding was that under Section 2.4(a) of this Financial Facility Agreement (at workpaper Perm File II-3.5), the City had the option to extend the maturity date to November 1, 2010. This option was entirely within the control of the City. We understood that the reason for this extension was to ready the property for lease to BNSF Railway Company with which the Bell Public Financing Authority already had lease agreements in place on adjacent property (Permanent File II-4 documents, an existing lease with BNSF) or embark in new negotiations with a prospective lessee or buyer. The due date of this note, when considered in the 6-30-2009 audit, was 16 months beyond the fiscal year end. AU341.02 limits the auditor's responsibility for going concern issues to a reasonable period of time, not to exceed 12 months from the balance sheet date. The City did in fact continue as a going concern for 12 months following the June 30, 2009 audit period, notwithstanding the lease extension the SCO discusses. Moreover, the SCO indicated that it cannot determine based upon our audit workpapers whether the City could meet its obligations and debt service payments. Our audit workpapers for long-term debt included third party confirmation of all significant debt as of 6-30-2009. Those audit workpapers at K-0 to K-7,4 documented that all debt payments were current, none were in default. We also inquired in our 3rd party verification of knowledge of any violations of bond covenants. There were no exceptions. Also, based upon the audit team key members' knowledge from prior year audit engagements, there had been no violations or non-payment on debt issues in prior years. Further, other than the issue discussed above on the $35,000,000, Series 2007 Financial Facility Agreement, there was no evidence at 6-30-09 that the City or its component units could not meet their obligations as they became due in the next 12 months (the reasonable time frame). That fact was documented in our audit program sign-off step 10(a) in workpaper 4-1.

The following are specific responses to the SCO comments on the financial statements:

- The General Fund expenditures exceeded revenues by $1,754,266. Our firm considered this in our final review of the results by the Shareholder, Quality Control Reviewer, Engagement Manager and Engagement Senior during their respective reviews of the financial statements of the City documented at 1-1(d) to 1-3(b) and 4-11 and on the Report Control Sheet Copies provided to the SCO upon commencement of its review. The General Fund of the City had positive fund equity of $15,686,907. This issue did not present a risk that the City could not continue as a going concern for the one year reasonable period.
- The Retirement Special Revenue fund had a deficit of $3,049,483. Our audit team considered this in our documented review of the audited financial statements (at workpapers 1-1(d) to 1-3(b). Based upon the fact that the City's General Fund had positive general fund balance at June 30, 2009 of $15,686,907, this issue did not present a risk that the City could not continue as a going concern for the one year reasonable period.
- The Community Redevelopment Agency in the CAFR had a deficit at June 30, 2009 of $3,650,536. The reason for this deficit was that the Government Finance Officers Association (GFOA) and Generally Accepted Accounting Principles (GAAP) require that, for CAFR presentation purposes, long-term advances be reflected as a fund liability (rather than proceeds of long-term debt) (See GASB Codification Section 2600.120). The long-term advances of $6,127,286 created the deficit. This does not create a going concern issue in that the deficit is created by a long-term liability to a related party with no impact on cash flow with respect to the time frame relevant for evaluation for going concern purposes under relevant audit and accounting requirements. It should be noted that the separate component financial statements issued for the RDA properly reported a positive fund balance at June 30, 2009 in the Debt Service Fund of $2,476,750, as required by GAAP applicable to separately issued component unit financial statements.
- The Public Financing Authority Debt Service Fund had a deficit at June 30, 2009 of $2,186,184. Based upon the fact that the General Fund had positive fund equity of $15,686,907 at June 30, 2009, this issue did not present a risk that the City could not continue as a going concern during the one year reasonable period.

All of the foregoing was considered as set forth in the practical considerations of our audit program at workpaper 4-1. In summary and in our professional judgment and experience as independent auditors of municipalities in California, we concluded and documented the conclusion that there was not substantial doubt concerning the ability of the City to continue as a "going concern" for 12 months after the balance sheet date. Accordingly, no additional language was required to be included in the auditor's report with respect to this issue. Further, we believe that the disclosures regarding the subsequent event in Note 17 together with the disclosure in Note 7 of the CAFR properly and completely disclosed the terms and due dates of the 2007 Taxable Lease Revenue Bonds in the principal amount of $35,000,000. These dates fell outside of the window that would raise a going concern uncertainty. Further, we believe that the disclosures provided in the financial statements provided sufficient transparency so as to not mislead the users of the financial statements with regard to these issues. It should be noted that GASB Statement No. 56 makes it clear that the financial statement preparer (i.e., the City) — not the auditor— is primarily responsible for evaluating whether there is substantial doubt about the

City's ability to continue as a going concern. This is stated clearly in paragraph 16 of that standard. It is important to note that GASB No. 56 establishes accounting and financial reporting standards, not auditing standards which are established by SAS No. 59. Furthermore, GASB No. 56 extends the consideration of going concern issues beyond the 12-month period established by SAS No. 59. This indicates that City management has a responsibility to report going concern issues that extend beyond those responsibilities placed on the auditor. In addition, GASB 56 paragraph 18 discusses that the effect of the governmental environment should be considered when evaluating indicators. Some conditions or situations identified in the indicators in GASB 56 paragraph 17 should be assessed differently. For example, recurring operating losses are commonplace for some business-type activities such as transit operations or governmental healthcare organizations. Governments may choose to subsidize these operations for political reasons. Thus, governments may have funds with deficit fund balances which will be "remedied" by transfers from the general fund.

We also note that SCO referenced on page 15 of the draft report that "Practical Considerations" in the audit program stated that "a deficit in a debt service fund usually indicates poor financial management and may indicate overall financial distress." However, practical considerations contained in the audit programs are intended to provide additional information to the audit team as a general reminder. They are non-authoritative, and do not apply to all clients and situations. An affirmative response in the audit working papers is not required for each practical consideration.

(4) DOCUMENTATION AND EVALUATION OFSUBSEQUENT EVENTS WAS NOT DEFICIENT

We disagree with the SCO conclusion that there were deficiencies in our evaluation of subsequent events. The documentation of the subsequent events reviewed by the Senior Field Auditor (a key audit team member) on workpaper 4-5 clearly demonstrates the audit program steps and inquiries that were undertaken. Those steps referred to emails and attachments (which are attached to this response as Attachments 4, 5 and 6). This documentation includes all of the supporting signed amendments for the extension of the $35 million Taxable Lease Revenue Bonds.

We believe that the auditing standards of care for subsequent events were fully met. Searching the California Planning and Development Report would not be a generally accepted practice in a financial audit of a city. We were unaware of the article referred to by the SCO concerning the lease evaluation. As discussed above, the court's order was not disclosed in City minutes, in the City's written representations or by the City Attorney. As previously discussed and in the Attachment 5 referred to on workpaper 4-5, our audit team was advised of the exercise of the available extension option on the $35 million Taxable Lease Revenue Bonds. We believe that Notes 7 and 17 accurately disclose the documentation provided to our Firm pertaining to the $35 million Taxable Lease Revenue Bonds.

We also disagree with the SCO conclusion that the subsequent event procedures were not at or near the end of the date of the Auditor's report. Our Auditor's report was dated December 18, 2009 and our subsequent event procedures were all performed within four days of that date. Five copies (and a master) of the report were released to the client on December 22, 2009.

We concur that the emails referred to in the audit program sign-off should have been scanned into the electronic files; however, we believe this to be a minor documentation issue as the documents were referred to in the electronic workpaper at 4-5 and can easily be validated by another experienced auditor.

(5) IDENTIFICATION OF LITIGATION CLAIMS AND ASSESSMENTS WAS NOT DEFICIENT

We disagree with the SCO conclusion that there are any significant short-comings in our assessment of litigation, claims and assessments. Specifically, the draft SCO report suggested that since we failed to include in our workpapers a copy of the email that we received from the law firm with respect to the time frame through the date of our audit period, we did not conform to auditing standards. However, auditing standards do not require that such communication be performed via email or that if they were performed via email, that a copy of the email be provided in the workpapers. Our documentation on workpaper 4-3A substantially met the requirements of the standard except that the documentation at that workpaper showed 11/XX/09 as the date of our contact with the City Attorney, rather than the actual date of the emailed communication. The original notation of 11/XX/09 was a placeholder for our documentation of the final response from the attorney. Not changing that placeholder was a minor oversight with respect to the documentation of this issue. Further, on workpaper 4-3A and in the response of Edward Lee of Best, Best and Krieger, we were advised that his Firm was not aware of any pending or threatened litigation or unasserted claims that were probable of assertion. Mr. Lee and Best, Best and Krieger were the legal counsel for the City of Bell. If Mr. Lee and Best, Best and Krieger had advised us of a claim being handled by another law firm that could have an effect on the audited financial statements or disclosures, we would have followed up. There was no such disclosure included in Mr. Lee's response. We believe that our audit procedures (primarily confirmations with third party experts) met the standards of care for identifying litigation, claims and assessments.

The draft SCO report suggests that had we analyzed the $427,000 of legal expense recorded in the general ledger of the City, we would have noted that other firms were consulted besides Best, Best and Krieger. Local governments engage a variety of law firms for different purposes that are not relevant to the audit process. The auditor makes a determination of which law firms are dealing with matters significant to the determination of material matters affecting the financial statements based upon discussion with management so that requests for a response on such matters is sent to firms involved in matters where the City may be the defendant, in a case involving the potential reporting of a liability for claims and judgments. Had the $427,000 of legal fees been analyzed, the auditor would still have used the knowledge of management to ascertain the scope of service provided by each law firm. Such inquiry with management is appropriate and customary to assist the auditor in making a determination as to which law firms should be contacted to respond to audit inquiries regarding claims and judgments. The examination of every invoice paid during the fiscal year does not reflect the standard of care expected by GAGAS or GAAS with respect to the performance of local government financial statement audits.

In summary, other than the placeholder typographical error on workpaper 4-3A, all documentation is in the electronic files or was referred to in the electronic files and can be easily validated by another experienced auditor.

(6) TESTING OF FEDERAL PROGRAM COMPLIANCE REQUIREMENTS WAS NOT DEFICIENT

When our engagement audit team commenced planning and fieldwork in March, 2009 on the City of Bell audit, the March, 2009 supplement was not yet available and we utilized the 2008 compliance supplement in our audit files. The program objectives for the Department of Housing and Urban Development Community Development Block Grant, CFDA 14.218 in 2008 are exactly the same as the program objectives identified in the compliance supplement in 2009, with the exception of the Housing and Economic Recovery Act of 2008 (HERA). According to the 2009 Compliance Supplement, the use of NSP funds which were provided by HERA, to which additional compliance requirements would apply, include such activities as:

- Establish financing mechanisms for purchase and redevelopment of foreclosed upon homes and residential properties.
- Purchase and rehabilitate homes and residential properties that have been abandoned or foreclosed upon for later sale, rent or redevelopment.
- Establish land banks for homes that have been foreclosed upon.
- Demolish blighted structures
- Redevelop demolished or vacant properties.

When a Compliance Supplement is updated after the performance of preliminary audit work, we obtain the revised Supplement and compare the changed provisions to the Compliance Supplement that was utilized for the preliminary work performed. Where audit requirements changed for activities applicable to that client, we add the new or changed audit requirements to the Supplement utilized in our workpapers so that all relevant additional requirements will be attended to. Our comparison of the Supplement in effect during the planning stage of the audit and the Supplement in effect at the date of our opinion indicated that there were no significant additions or changes in compliance requirements or auditor testing responsibilities that required a reperformance of previously performed audit testing or the addition of further procedures.

In particular, it should be noted that the City of Bell did not use any of their CDBG funds for the activities identified above, nor was any of the City's CDBG grants funded through the HERA program. As a result, the additional program objectives and related compliance requirements associated with HERA were not applicable to the City of Bell and did not have a direct and material impact on the risk nature of the CDBG grant program as it related to the City of Bell for the year ended June 30, 2009. Accordingly, we did not modify the Compliance Supplement in use by our firm for the City of Bell audit to reflect the addition of audit steps that would not be applicable to the federal funding received by the City of Bell.

As of March 24, 2009, the City of Bell had incurred $479,397 of CDBG expenditures as documented at BB-2.1. Of the $479,397 of expenditures, $174,875 of expenditures were incurred from non-payroll activities. Our testing of the City's internal controls over this program included the testing of $73,000 of non-payroll expenditures incurred as of March 24, 2009, which represented 42% of expenditures incurred to that date. Our documentation of the controls

in place and our testing of those controls as performed at workpaper BB-2.3 identified no instances of non-compliance which demonstrated that the City internal controls over the CDBG program were operating effectively. The additional expenditures of $211,584 incurred from March 25, 2009 through June 30, 2009 were consistent with the activities tested in the first 9 months of the fiscal year and based on our testing performed; the internal controls over the CDBG program had not changed (e.g. key controls were unchanged and the personnel executing the key controls were the same experienced city staff) and were still effective which would not result in the need to test additional amounts. Of the $211,584 of expenditures incurred from March 25, 2009 through June 30, 2009, $113,433.71 of expenditures were incurred for the similar activities which were tested at workpaper BB-2.3.

Of the $479,397 of CDBG expenditures incurred as of March 24, 2009 as noted at workpaper BB-2.1, $304,521 of expenditures were from City staff payroll charges. These payroll expenditures represented the work of 9 City employees, of which 8 spend 100% of their time working on CDBG activities mainly consisting of Code Enforcement Officers and the Handyman and Rehabilitation program. Due to the fact that these 8 employees spent 100% of their time performing activities to allow the City to meet the program objectives of the CDBG program, there was no allocation of their salaries to any other department or program of the City. The one individual that was not 100% dedicated to the CDBG program had 44% of that individual's salary allocated to CDBG as a Code Enforcement Officer. Our workpapers documented at workpaper BB-3 that based on this individual's job duties, a 44% allocation was reasonable. In addition, according to the grant agreement with the County, these positions were budgeted for and approved by the County for the City's comprehensive code enforcement services in deteriorating areas to support rehabilitation and public improvement projects. The County of Los Angeles Community Development Commission approved the City's budget and contract No. 103329 which included the funding of these code enforcement officers to allow them to investigate approximately 45 cases, commercial and residential, per month. This audit documentation was in a manual workpaper bulk file provided to the SCO as an integral part of our workpapers.

AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

The City of Bell did not receive any grants or contracts associated with the American Recovery and Reinvestment Act of 2009 during the 2009 fiscal year. The addendum to the Compliance Supplement issued in August of 2009 addressed specific issues which pertained to ARRA funded programs. The City of Bell did not have any such programs. Through our inquiry of City staff, our review of the City staff prepared Schedule of Expenditures of Federal Awards workpaper SA-3-3, and our review of the City's trial balances, there was no indication that the City received ARRA funds which resulted in the addendum to the 2009 Compliance Supplement having a direct or material impact on the City federal award programs.

ALLOWABLE COSTS

As discussed, the City had 9 employees that charged time to the CDBG program; of those 9, 8 employees were directly charged to the program for 100% of their salaries. These 8 individuals did not have their time or costs allocated to any other department or program of the City. The one City Staff that had a portion of that individual's salary allocated to the CDBG program was 44% of the time, which our workpapers documented at workpaper BB-3 that based on this individuals job duty, the 44% allocation was reasonable. We believe that the audit procedures performed were adequate to insure that allocated salaries to the CDBG program were allowable costs and in compliance with OMB Circular A-133 and Circular A-87. Our audit procedures included a review of the City's grant agreement with the County, (Contract 103329 in our audit manual bulk file provided to the SCO), which specifically identified the individuals and their salaries approved to be charged to the CDBG program, and an interview with the one employee who's time was not 100% allocated to the program to document that the individuals job duties and day to day responsibilities were consistent with the allocation percentage used.

DAVIS BACON ACT

Per the Compliance Supplement, the requirements of the Davis-Bacon Act apply to the rehabilitation of residential property only if such property contains 8 or more units. However, the requirements do not apply to volunteer work where the volunteer does not receive compensation, or is paid expenses, reasonable benefits or a nominal fee for such services, and is not otherwise employed at any time in construction work (42 USC 5310; 24 CFR section 570.603). Based on the testing performed through March 24, 2009, the City did not engage any outside companies to perform construction work for the rehabilitation of residential property with 8 or more units, which caused in the Davis Bacon Act Compliance to not be an applicable compliance area for the City of Bell's CDBG program. As of March 24, 2009, the City incurred $174,875 of non-payroll expenditures of which $73,000 was tested for being allowable and within the program objectives and requirements. From March 25, 2009 to June 30, 2009, the City's administration of the CDBG program was not changed, nor did the City spend or contract with any company to perform construction work, which would have made this compliance area applicable. Additionally, had the City made a decision to change their program activities to include such work as the rehabilitation of residential properties of 8 or more units, evidence of this commitment would have been identified in our review of Council minutes or through our inquires of management, which did not exist and did not occur. Furthermore, based on our review of the final trial balances at TB.1, (a paper file that was part of the bulk documents provided to the SCO), there were no new accounts nor were there any significant changes to the activities of this program. As such, our testing of controls and evaluation of the applicability of the Davis Bacon Act was unchanged as of June 30, 2009. The Davis Bacon Act compliance requirement was not applicable to the City of Bell CDBG program.

PROGRAM INCOME

As stated by the SCO, our compliance testing documented at workpaper JJ-1 indicated that our testing demonstrated that the City was accurately accounting for program income. Documentation and interviews with the contract CDBG Coordinator at workpaper LL-4

supported that internal controls over program income were operating effectively. During the year ended June 30, 2009, one loan for $20,000 was repaid, which is program income. However, per the compliance supplement, testing of program income is only needed if program income exceeds $25,000. The guidance specifically states:

> The grantee must accurately account for any program income generated from the use of CDBG funds and must treat such income as additional CDBG funds which are subject to all program rules. Program income does not include income received in a single program year by the grantee and all of its subrecipients if the total amount of such income does not exceed $25,000 (emphasis added) (24 CFR sections 570.500, 570.504, and 570.506).

As such, our testing of this area was appropriate and in compliance with OMB Circular A-133 and the 2009 compliance supplement. Program Income compliance requirement was not applicable to the City of Bell CDBG program, and did not have a direct and material impact on the federal program for the year ended June 30, 2010.

FINANCIAL REPORTING

Our workpaper documentation at workpaper LL-4 discusses the process that we documented regarding the CDBG Funding Request (which we believe is equivalent to SF-272 Federal Cash Transactions Report). We interviewed program personnel and documented controls over claims and financial reporting. We believe this to be adequate documentation.

The testing of the City's performance reporting consisted of insuring the amounts of expenditures reported agreed to the underling accounting records, which we performed and documented at workpaper LL-2. This testing was only performed as an audit procedure to verify the amounts reported in the client's Schedule of Federal Awards, and not as a test of controls or compliance with the provisions related to performance reporting.

The performance reporting compliance requirement for the CDBG program per the 2009 Compliance Supplement requires that only prime recipients comply with the HUD 60002, Section 3 Summary Report, Economic Opportunities for Low- and Very Low-Income Persons (OMB No. 2529-0043). The City of Bell is a subrecipient from the County of Los Angeles. The County of LA is responsible for this reporting requirement, not the City of Bell. As such, this compliance step was not applicable to the City.

> "HUD 60002, *Section 3 Summary Report, Economic Opportunities for Low- and Very Low-Income Persons, (OMB No. 2529-0043)* – For each grant over $200,000 that involves housing rehabilitation, housing construction, or other public construction, the prime recipient must submit (emphasis added) Form HUD 60002. (24 CFR sections 135.3(a), 135.90, and 570.607).

SPECIAL TESTS AND PROVISIONS

The City of Bell, as a subrecipient of CDBG funds from the County of Los Angeles, is included in the County's Citizen Participation Plan (documented at workpaper NN-1), and the activities documented as part of the County's plan and included in the grant agreement are consistent with the program objectives. Our testing of the grant agreement, the County of Los Angeles Monitoring report and the Citizen Participation Plan clearly indicate that the City has developed and implemented an appropriate Citizen Participation Plan.

The compliance requirements relating to the request for release of funds (RROF) and environmental reviews are not applicable to the City of Bell's CDBG program. These approvals and reviews are exempt, per CFR 24, Section 58.35(a)(3) as noted below.

> Title 24 - Housing and Urban Development Subtitle A - Office of The Secretary, Department of Housing and Urban Development
>
> Part 58 - Environmental Review Procedures For Entities Assuming HUD Environmental Responsibilities
>
> Subpart D - Environmental Review Process: Documentation, Range of Activities, Project Aggregation and Classification
>
> 58.35 - Categorical exclusions.
>
> Categorical exclusion refers to a category of activities for which no environmental impact statement or environmental assessment and finding of no significant impact under NEPA is required, except in extraordinary circumstances (see 58.2(a)(3)) in which a normally excluded activity may have a significant impact. Compliance with the other applicable Federal environmental laws and authorities listed in 58.5 is required for any categorical exclusion listed in paragraph (a) of this section.
>
> > (a) Categorical exclusions subject to 58.5. The following activities are categorically excluded under NEPA, but may be subject to review under authorities listed in 58.5: (1) Acquisition, repair, improvement, reconstruction, or rehabilitation of public facilities and improvements (other than buildings) when the facilities and improvements are in place and will be retained in the same use without change in size or capacity of more than 20 percent (e.g., replacement of water or sewer lines, reconstruction of curbs and sidewalks, repaving of streets).
>
> (3) Rehabilitation of buildings and improvements when the following conditions are met: (i) In the case of a building for residential use (with one to four units), the density is not increased beyond four units, the land use is not changed, and the footprint of the building is not increased in a floodplain or in a wetland; (ii) In the case of multifamily residential buildings: (A) Unit density is not changed more than 20 percent; (B) The project does not involve changes in land use from residential to non-residential; and (C) The estimated cost of rehabilitation is less than 75 percent of the total estimated cost of replacement after rehabilitation.

(b) Categorical exclusions not subject to 58.5. The Department has determined that the following categorically excluded activities would not alter any conditions that would require a review or compliance determination under the Federal laws and authorities cited in 58.5. When the following kinds of activities are undertaken, the responsible entity does not have to publish a NOI/RROF or execute a certification and the recipient does not have to submit a RROF to HUD (or the State) except in the circumstances described in paragraph (c) of this section. Following the award of the assistance, no further approval from HUD or the State will be needed with respect to environmental requirements, except where paragraph (c) of this section applies. The recipient remains responsible for carrying out any applicable requirements under 58.6.

(7) EVALUATION OF INTERNAL CONTROLS OVER MAJOR FEDERAL PROGRAMS WAS NOT DEFICIENT

CASH DISBURSEMENTS

We disagree with the SCO conclusion that we did not plan or perform tests of internal controls. In addition to documenting our understanding of internal controls over the Community Development Block Grant (CDBG) expenditures, we documented in workpapers AA-1 and BB-1 that CDBG grant expenditures are handled through the normal City cash disbursement process and workpapers AA-1 and BB-1 also referred to the test of controls workpaper over non-payroll transactions. The CDBG internal control documentation workpapers also state that payroll expenditures are handled through the normal City payroll process and refer to the test of controls workpaper over payroll transactions. In addition, we performed dual purpose tests of transactions to support a low level of control risk and to also substantively address a significant percentage of grant dollars expended. The tested transactions supported the strength of internal controls that were evaluated in our audit. These transactions were found to be in conformity with applicable compliance requirements, thereby demonstrating the effectiveness of program controls that were applied to these transactions.

Per the AICPA Audit and Accounting Guide, Governmental Audits and Circular A-133, AAG-SLA 9.22 indicates the following as it relates to testing of internal controls over major Federal programs:

> Circular A-133 states that the auditor should plan the test of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. Professional standards do not define or quantify a low assessed level of control risk of noncompliance. Therefore, professional judgment is needed in determining the extent of control testing necessary to obtain a low level of control risk of noncompliance.

ELIGIBILITY

The workpaper referenced in the SCO's report is related to the Special Tests and Provisions section of the compliance supplement related to Rehabilitation, not Eligibility. We included the following statement in our internal control documentation at workpaper AA-1: "N/A – not an applicable area as per compliance requirement" which agrees with the SCO's comments that eligibility requirements are not applicable to the CDBG program. Accordingly, there was no issue of deficiency on this issue with respect to audit documentation.

FINANCIAL REPORTING

The auditing standards allow the auditors to limit the amount of substantive testing they perform if they assess control risk as low by testing controls. In fact, we tested all material CDBG Funding Requests at workpaper LL-3 (a manual document provided as a part of our bulk file to the SCO). Testing all material CDBG Funding Requests provides greater evidence that reports

were filed in accordance with federal requirements. Our dual purpose testing of these funding requests met not only the substantive objectives of the test, but also provided evidence of the quality of internal controls surrounding the preparation of the funding requests by noting the results of the application of internal control with respect to the funding requests tested (i.e., those internal controls resulted in funding requests tested by the auditors to be properly prepared and in conformity with the requirements for their preparation).

(8) AUDIT DOCUMENTATION REGARDING REDEVELOPMENT AGENCY WAS NOT DEFICIENT EVIDENCE

We disagree with the SCO conclusion that the "temporary" listing of the Bell Community Redevelopment Agency on the SCO listing of sanctioned Redevelopment Agencies was a matter of non-compliance that would have had a direct and material effect on the financial statements of the Bell Community Redevelopment Agency for the year ended June 30, 2009. The following are the reasons:

- On July 7, 2009, the SCO made a report to the legislature of the State on Property Tax-Pass-through Payments-Health & Safety Code Section 33684.
- In the SCO report of July 7, 2009, the Bell Community Redevelopment Agency was one of 19 Agencies in the State that had not received concurrence with their County Auditor-Controller on their pass-through payments. On Page 80 of the SCO report to the legislature, the reason listed was "Dispute Type #16". On Page 79, the description of dispute issues was "Agency disagrees with the base years used in the calculations."
- As indicated by the SCO report, this was an issue of legal dispute, not a reportable instance of non-compliance.
- On Page 79 of the SCO report to the legislature, the SCO stated "neither the SCO nor any other state agency has provided instructions on how to resolve disputes."
- The amount of the base year pass-through in question that was in dispute with the Bell Community Redevelopment Agency was:

LA Community College	$ 7,658
LA Country Office of Education	1,186
LA Unified School District	8,396
Montebello Unified School District	46,526
	$63,766

The LA County Auditor-Controller and the Finance Staff of the Bell Community Redevelopment Agency subsequently resolved the dispute. The Bell Community Redevelopment Agency was removed from the listing as of September 1, 2010.

- The Review Report of selected transactions issued by the SCO for July 1, 2000 through June 30, 2010 (10 years of review) released final on October 20, 2010 to the City of Bell Interim City Administrator, Pedro Carrillo, made no mention of Health and Safety Code Section 33684 on AB 1389 issues because they were legal issues that had been resolved.
- The City of Bell Legal Representation Letter at workpaper 43(b) and follow-up correspondence (Attachment #6) made no mention of any material non-compliance issues.

- The City of Bell Management Representations as of December 18, 2009 (Attachment #9) made no mention of any matters of material non-compliance.

The SCO has referred to the extensive documentation that we completed to comply with Redevelopment Agency Audit Guide Requirements. However, the SCO has questioned audit program sign-off for seven procedures (9, 10 and 12-16) in our audit program.

- Step 9 clearly referred to workpaper R-3 series where we tested the largest project/expenditure charged to the fund. Step 9 clearly referred to a conclusion to our testing. Our conclusion was "Based upon the testwork performed, the single largest expenditure in the low-mod fund resulted in no construction or rehabilitation of affordable housing or eliminated specific conditions jeopardizing the health and safety of low and moderate housing residents for fiscal year end June 30, 2009."
- Step 10 - We noted no material expenditures in our testing of expenditures for expenditure outside the project area. We referred to R-3 series as noted in the conclusion above. We signed off the audit step and believe our audit work met professional standards.
- Step 12 – Our audit documentation clearly indicates at workpaper 4-2A that our audit team reviewed documentation supporting the City Clerk's production of minutes. We reviewed redevelopment agency minutes from July 1, 2008 through the date of our audit report.
- Step 13 and 14 in our audit program refer to a compliance request list that was completed and returned to our audit staff by the DAS of the City of Bell. Step 6 of our questionnaire at R-2, documented by Bell City Staff, indicated no changes were made in public notification notices procedures. Our documentation completed and provided by the Director of Administrative Services at workpaper R-2 also indicates that all public disclosure notices were made and there had been no changes in procedures during the year per workpaper R-2. We believe our documentation supported our audit steps being signed off.
- Step 15 - We previously provided the SCO with the Bell Redevelopment Agency Conflict of Interest Policy RDA Permanent File III-3-1. We believe the Conflict of Interest Policy appropriately addresses Government Code 87300, Title 9, chapter 7 of the Government Code and other questions intended in the compliance audit step. We believe our audit sign off and documentation was appropriate. Other steps in our audit program at Step 15 referred to the questionnaire completed under the supervision of the City's DAS and provided as documentation at workpaper R-2. All audit steps were completed appropriately.
- Step 16 referred to by the SCO clearly documented by our engagement team regarding Land Held for Resale and discussions with the client (Senior Accountant) indicated that no land was sold during the year. Further, documentation at D-5 of the Land Held for Resale workpaper prepared by the City's Senior Accountant indicated that there was no property held for resale sold during the year. Our review of Redevelopment Agency minutes also supported this assertion by City management and our conclusion. All conclusions and documentation were appropriate.

Finally, based upon the foregoing explanations, we believe that the SCO can rely upon the compliance audit work supporting our opinion on compliance for the year ended June 30, 2009.

(9) TESTING OF COMPLIANCE WITH THE REDEVELOPMENT AGENCY AUDIT GUIDE WAS NOT DEFICIENT

Our team has developed a California Supplement audit guide that was documented in the audit workpapers at workpaper R-O. This audit guide included consideration for documentation of more than 80 steps that addressed all 28 audit program areas contained in the Guidelines for Compliance of California Redevelopment Agencies that were issued by the California State Controller.

Of the more than 80 steps for which we obtained audit evidence, the SCO has identified the following areas of concern:

- The State Controller's draft report concluded that our workpapers did not contain documentation that the planning and administrative expenditures were necessary for the production improvement or preservation of low and moderate income housing. We disagree with the SCO conclusion. Our workpapers contained evidence of our examination of the trial balance of the Low and Moderate Income Housing Fund. This review indicated that planning and administrative expenditures of the Low and Moderate Income Housing Fund were not material. Nevertheless, testing was performed and our testing of certain charges to the fund indicated that such charges were for the improvement and preservation of low and moderate income housing. The nature and extent of audit testing is a matter of professional judgment. Our consideration of such testing in this case reflected a reasonable application of professional judgment.
- The State Controller's draft report suggested that trial balances for Fund 22 (low-mod Fund) for the year ended June 30, 2009 which were reviewed by the Audit Engagement Team for the entire year and documented on the trial balances included total expenses for the year audited (including salaries, fringe benefits, supplies and court administrative fee and other minor charges) of $161,313 for the entire year. Our audit sampling reviewed the documentation of $14,863 as stated by the SCO (13.16% of expenditures incurred through March 2009 and 9.2% of expenditures incurred for the entire fiscal year). Our review of the trial balance of the Low and Moderate Income Housing Fund indicated that the dollar amount of salaries charged to the fund was not unreasonable in view of the level of effort typically demanded by such funds. Approximately 10% of the salaries of certain personnel were charged to the Low and Moderate Income Housing Fund. The majority of the planning and administrative expenses subject to the written determination requirement of the Low and Moderate Income Housing Fund pertained to the minimal amount of salaries charged to the fund. Although not material, we concur that our audit workpapers did not include retention of a client-prepared written determination as to the basis for the specific salaries that were charged to this fund.
- The county administrative fee represents an area of legal uncertainty with respect to applicability to all funds that receive an allocation of property taxes for the Agency. In the absence of a clear statement as to this issue in the Health and Safety Code, it is not uncommon, in our experience, for agencies to reasonably allocate the county's administrative fee to all funds that receive the benefit of the county's administration of

property taxes. This is not an unreasonable position of agencies that take that view and a legal determination as to this would be outside the purview of a financial statement audit.

- The other charges mentioned in the State Controller's draft report were clearly immaterial (cell phone charges, etc.) and would not warrant additional testing, in our opinion.

We did not extend the testing performed during the interim stage of our audit because our review of trial balances obtained at year end indicated that there was not significant new activity incurred after our interim testing to warrant an extension of such testing. This review consisted of a comparison of the activities (and their magnitude) that existed during our interim testing (March 26, 2009) and year end June 30, 2009. We concur that our documentation of this consideration should have been better documented in the workpapers.

In summary, of the more than 80 audit steps for compliance conducted by our Firm, we believe that the following should be the SCO conclusion:

- The Firm did not obtain a client-determined analysis to support the allocation of administrative salaries that were made to the Low and Moderate Income Housing Fund.

The foregoing Redevelopment Agency findings constitute an immaterial instance of non-compliance on the part of the Agency and an immaterial departure in documentation standards with respect to our documentation of procedures required to be performed.

ATTACHMENT #10

John Chiang's Letter of Understanding dated 8-2-2010 Regarding City of Bell Quality Control Review

JOHN CHIANG
Controller of the State of California

August 3, 2010

Stephen J. Tully
Garrett & Tully
4165 E. Thousand Oaks Blvd.
Suite 201
Westlake Village, CA 91362

Dear Mr. Tully,

This letter is to confirm my telephone conversation with you on August 2, 2010 regarding a scheduled State Controller's Office (SCO) quality control review of Mayer Hoffman McCann P.C. The entrance conference has been scheduled for August 5, 2010 at 9:00 a.m.

A single audit of any governmental unit must be performed in accordance with the standards referred to below. According to OMB Circular A-133, the auditor's work is subject to a quality control review at the discretion of an agency granted cognizant or oversight status by the federal funding agency.

As the coordinating agency for single audits of local governments, the SCO may perform quality control reviews of audit working papers to determine whether audits are performed in conformity 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 of America.

We will be reviewing the working papers of Mayer Hoffman McCann P.C.'s audit of the City of Bell for the period July 1, 2008 to June 30, 2009. The planned amount of fieldwork time will be determined based on the documentation available. We will require office space for two reviewers during the fieldwork portion of the review and availability of staff to answer questions.

Our purpose will be to determine if the audit was conducted in accordance with:

- U.S. generally accepted auditing standards (GAAS) and AICPA's professional standards (*Statements on Auditing Standards*).
- *Government Auditing Standards*, issued by the Comptroller General of the United States (GAGAS).
- Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*.
- California *Business and Professions Code*.

We will hold an exit conference after fieldwork is completed; however, we will keep the firm informed of any issues or concerns that may arise during our review. A draft report will be issued when the review is completed. The report will reflect one of four conclusions:

- The audit was performed in accordance with applicable standards and requirements for financial audits and compliance audits.
- The audit was performed in accordance with the majority of applicable standards and requirements for financial and compliance audits.
- The audit was performed in accordance with some elements of applicable standards and requirements for financial and compliance audits; however, the majority of auditing standards and requirements were not met.
- The audit was not performed in accordance with applicable standards and requirements for financial and compliance audits.

A final report will be issued after the firm has an opportunity to review and respond to the draft report.

Attached is a documentation request. Please have these items available when we begin fieldwork.

If you have any questions please call me at (916) 322-7656.

Sincerely,

Original signed by

CAROLYN BAEZ, CPA
Manager
Financial Audits Bureau
Division of Audits

Attachment

cc: Casandra Moore-Hudnall, Chief
Financial Audits Bureau
Division of Audits

Sunny Okeke, Auditor
Financial Audits Bureau
Division of Audits

Appendix 2—
Firm's December 8, 2010
Additional Response to Draft Review Report

MHM
Mayer Hoffman McCann P.C.
An Independent CPA Firm

2301 Dupont Drive, Suite 200
Irvine, California 92612
949-474-2020 ph
949-263-5520 fx
www.mhm-pc.com

December 8, 2010

Via Email and Overnight Delivery

Jeffrey V. Brownfield
Chief, Division of Audits
California State Controller's Office
3301 C. Street, Suite 700
Sacramento, California 95816

Dear Mr. Brownfield:

We have previously provided an extensive response to the draft report of the California State Controller's Office (SCO) on the quality control review of Mayer Hoffman McCann P.C.'s (MHM or the Firm) audit workpapers for the City of Bell, California for the year ended June 30, 2009. Rather than repeating all of our responses from our November 11, 2010 correspondence, we incorporate them by reference in this document.

In addition to our summarized comments below, a separate communication dated December 8, 2010 from legal counsel at Garrett & Tully, P.C. representing Mayer Hoffman McCann P.C. is an integral part of our response to the SCO. That communication addresses the conduct of the SCO in the performance of the quality control review.

We believe that our Response dated November 11, 2010, the matters communicated to the SCO in the Exit Conference held on December 3, 2010 and the matters included and referenced in this letter support and require an objective conclusion that –

- **Mayer Hoffman McCann P.C.'s audit was performed in accordance with a majority of the applicable standards and requirements for financial and compliance audits.**

OBJECTIVE OF A FINANCIAL STATEMENT AUDIT VS. THE OBJECTIVE OF A FRAUD AUDIT

We were engaged to perform an audit of the financial statements of the City in accordance with Generally Accepted Auditing Standards and Generally Accepted Government Auditing Standards. The objective of such an engagement is to express an opinion on whether the financial statements are free from material misstatement. That objective is significantly different than a fraud audit which is typically designed to be very narrow and focused in scope (often with the knowledge that a fraud has likely occurred) on a specific risk, account balance or class of transactions, without the concepts of materiality called for in the financial statement auditing standards.

In using a hindsight approach, and having access to the various special investigation fraud audits that have been conducted in 2010 focused on specific activities of the City, the SCO has taken an approach that if a matter was identified in the various special investigation fraud audits, then it automatically is a violation of professional standards, if the financial audit of MHM did not uncover the matter. This is not an appropriate basis for evaluating MHM's compliance with professional standards.

SCO CONSIDERED DIFFERENCES OF OPINION IN PROFESSIONAL JUDGMENT AS NON-COMPLIANCE WITH PROFESSIONAL STANDARDS

During the exit conference, the SCO provided explanations of two of their findings stating that if we had performed an additional test in each of these two areas, the problems identified in the press in 2010 may have been detected. With the benefit of hindsight, the SCO reached the conclusion that we had not complied with professional standards because we had not performed these two additional tests. These two tests are not required by professional standards. They are procedures that an auditor may or may not elect to perform based on his or her risk assessments conducted during planning or as the engagement progresses. Basing a conclusion regarding MHM's compliance with professional standards on the subjective professional judgment, applied using hindsight and with information not available to the engagement team at the time of the audit, of expanding certain audit tests is not appropriate.

GENERAL COMMENTS REGARDING AUDIT DOCUMENTATION

A majority of the comments in the SCO draft report dealt with a single standard, the documentation standard. Although there were certain cases where our documentation of certain audit considerations was not in strict compliance with documentation standards in the Yellow Book and/or Statement on Auditing Standards No. 103, the totality of audit work performed did, in fact, demonstrate –

- The performance of an appropriate mix of audit procedures and testing to support our audit opinion and,
- The compliance with the majority of the professional auditing standards.

Because most of the issues identified by the SCO draft report pertained to the documentation standard, rather than deficiencies in the performance of the audit, the SCO report should acknowledge this by concluding that we complied with the majority of auditing standards.

At the Exit Conference, we requested the SCO provide to Mayer Hoffman McCann P.C. the documentation that supports the SCO's conclusion as to whether a majority of applicable standards and requirements for financial and compliance audits had been met. We did not receive a response. We repeat that request in this letter.

SUPPLEMENTAL INFORMATION

As a supplement to the information provided in our original response to the SCO's draft report, we also provided the following significant information during our exit conference with the SCO on December 3, 2010:

Finding One:

As indicated in our exit conference, we did not rely solely or primarily upon analytical procedures as implied in the SCO draft report with respect to accounts receivable, capital assets, and payroll. Professional auditing standards call for the auditor to use professional judgment in determining the mix of tests to achieve the objective of the financial statement audit.

- For accounts receivable, we also performed tests of controls over the revenue cycle, cut-off tests, and examination of supporting documentation for individually significant components of receivable balances.
- For capital assets, we performed tests of controls and examined support for 36% of current year additions (an unusually high percentage of testing).
- For payroll-related items, we tested internal controls, performed cut-off tests, performed fraud and other inquiries, reviewed receivable support and disbursement transactions (for unrecorded loans), and obtained management representations.

Contracts, Grants, and Laws:

- During our exit conference, we provided a print out of the "dashboard" summary of our electronic audit workpapers that clearly indicated the "integrated" approach that we used to document throughout the audit our consideration of compliance with contracts, grants, and laws. This "dashboard" summary was available to the SCO auditors throughout their quality review, but apparently not considered in the SCO's findings. The print out of this electronic workpaper clearly documented the performance and timing of bond compliance testing (performed in October 2009), investment compliance testing (performed in March 2009), Constitution Article 13B testing (performed in March 2009),

redevelopment compliance testing (performed in March 2009), and grant compliance testing (performed in March 2009).

Finding Three:

- As indicated in our exit conference, there is no evidence to suggest that the City's exercise of an existing contractual right (approved by the city council) to extend debt service on its $35 million bond created substantial doubt about the City's ability to continue as a going concern due to the circumstances of its renewal (to ready the property for its intended use).

Finding Five:

- As indicated in our exit conference, we inquired of outside legal counsel (which constitutes 3rd party audit evidence) of the existence of litigation, claims or other issues and received a response that there were no such matters. We relied on this evidence in determining that no further work was necessary.

Finding Six:

- As indicated in our exit conference, program income regulations only apply when program income exceeds $25,000. Because the City's income did not meet that threshold, the regulation is not applicable.
- As indicated in our exit conference, Federal Form SF-272 is not applicable to subrecipient agencies such as the City of Bell.

Finding Eight:

During our exit conference, we provided the following information regarding the redevelopment agency's placement on the state's "sanctions" list:

- The agency was placed on the sanction list during the fiscal year after the end of the audit period covered by our audit report (July 7, 2009)
- The agency's placement on the sanction list was based on an issue of dispute (subsequently resolved and cured between the parties) involving $63,766.
- This issue of dispute between the parties was not "direct and material to the determination of financial statement amounts" for the year ended June 30, 2009.
- This subsequent event (placement on the sanction list after the balance sheet date) was not truthfully responded to by the City in response to our inquires regarding subsequent events
- The City's written representations in the representation letter omitted the Agency's status with respect to the sanction list.
- The third party attorney letter omitted the Agency's status with respect to the sanction list.

- The Agency's placement on the sanction list was temporary and the Agency is currently not on the sanction list.

We will continue to cooperate with all parties in the regulatory and law enforcement agencies.

Mayer Hoffman McCann P.C.

MAYER HOFFMAN McCANN P.C.

Attachment

1. Garrett & Tully, P.C. Letter dated December 8, 2010

Appendix 3—
Firm's December 18, 2010 Letters

Mayer Hoffman McCann P.C.
An Independent CPA Firm

11440 Tomahawk Creek Parkway
Leawood, Kansas 66211
913-234-1900 ph
913-234-1100 fx
www.mhm-pc.com

December 18, 2010

Via Email and Overnight Delivery

Jeffrey V. Brownfield
Chief, Division of Audits
California State Controller's Office
3301 C. Street, Suite 700
Sacramento, California 95816

Dear Mr. Brownfield:

In our letter dated December 8, 2010, we referenced a correspondence dated December 8, 2010 from legal counsel at Garrett & Tully, P.C. as an integral part of our response to the California State Controller's Office (SCO) on the quality control review of our workpapers for the City of Bell, California. Mayer Hoffman McCann P.C. is committed to the renewed efforts of the firm and the SCO to work together in pursuit of the facts and resolution of the issues the review has raised. The claims in counsel's December 8 letter, as well as the request for investigation, are therefore withdrawn. MHM specifically withdraws comments or inferences in the letter concerning the intentions or motivations of the SCO, based on communications we have since had with the SCO, and the expectation of further discussions regarding this and other issues raised by the review. Additionally, the request for documentation/PRA by Garrett & Tully is withdrawn. Accordingly, our reference to the Garrett & Tully, P.C. correspondence dated December 8, 2010 should be removed from our response.

Thank you.

Mayer Hoffman McCann P.C.

Mayer Hoffman McCann P.C.
An Independent CPA Firm

11440 Tomahawk Creek Parkway
Leawood, Kansas 66211
913-234-1900 ph
913-234-1100 fx
www.mhm-pc.com

December 18, 2010

Via Email and Overnight Delivery

John Chiang
Jeffrey V. Brownfield
Cassandra Moore-Hudnall
California State Controller's Office
3301 C. Street, Suite 700
Sacramento, California 95816

Gentlepersons:

As requested by the SCO, we are providing new information at this time with respect to the report of the California State Controller's Office (SCO) on the quality control review of Mayer Hoffman McCann P.C.'s audit workpapers for the City of Bell, California for the year ended June 30, 2009.

During the conduct of this review, Mayer Hoffman McCann P.C. engaged legal counsel to assist us in the coordination of the review. Our legal counsel inquired during the review whether the SCO had questions or wished to talk with Mayer Hoffman McCann P.C. auditors directly, and was told that the SCO was comfortable with the line of communication through counsel. We now understand that SCO auditors usually meet with and conduct interviews with the audit team that worked on the engagement as a standard procedure. We encourage that the SCO follow its standard protocol and we will make our key personnel on the audit team available to meet with the SCO representatives.

The new information that we believe the SCO auditors will receive from such meetings is to learn first-hand from those individuals who interacted with City employees and officials the extent of the massive collusion involving City employees and officials that has been revealed in press reports and the SCO's additional investigations subsequent to our June 30, 2009 audit engagement. Such collusion appears to have been systemic with the intent to circumvent the City's fraud prevention polices and to deceive the auditors in the performance of their duties. We believe this new information raises significant issues that certainly relate to the purpose and propriety of the procedures employed in the audit under review, but also more generally to profession-wide concerns about the risk of collusion in a financial statement audit and the standards currently utilized to address that risk.

In addition, Mayer Hoffman McCann P.C. has given considerable thought into recommendations to prevent the events of the City of Bell from ever occurring again in the future. We would appreciate the opportunity to share our suggestions and work together with the SCO in future to enhance procedures for more transparent and robust financial reporting and disclosures, improved governance, as well as improved audit standards and furthering the mission of the SCO. We are prepared to offer over a dozen of new audit, oversight and governance procedures for consideration.

Thank you for your consideration of this request.

Mayer Hoffman McCann P.C.

State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, California 94250-5874

http://www.sco.ca.gov