



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

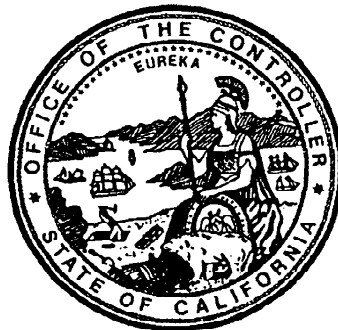
cc: Pedro Carrillo
Interim Chief Administrative Officer
City of Bell
Stephen J. Tully, Attorney
Garrett & Tully, P.C.
Paul Riches, Deputy Director
Enforcement and Compliance Board of Accountancy

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

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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 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 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