

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 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 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 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 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.

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 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 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 its 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 cited 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 I-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	<u>2,186,184</u>
Total	<u>\$ 8,886,203</u>

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 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 3<sup>rd</sup> 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.