AU 560.11 states:

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

AU 560.12 states, in part:

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

Recommendation

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

Firm's Response

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

subsequent event procedures were all performed within four days of that date. Five copies (and a master) of the report were released to the client on December 22, 2009.

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

SCO's Comment

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

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

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

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

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

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

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

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

Our finding and recommendation have been revised.

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

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

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

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

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

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

AU 337.05 section states, in part:

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

a. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.

b. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel, and obtain assurances from management, ordinarily in writing, that they have disclosed all such matters required to be disclosed by Statement of Financial Accounting Standards No. 5.

c. Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers. . . .

AU section 337.08 states, in part:

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

AU section 9337.05 states:

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

GAGAS 4.19 states, in part:

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

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

Recommendation

The firm should:

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

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

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

Firm's Response

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

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

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

SCO's Comment

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

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

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

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

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

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

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

Our finding and recommendation remain unchanged.

Noncompliance With OMB Circular A-133 Requirements

FINDING 6— Deficiencies in testing federal program compliance requirements

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

Part 1 of the Compliance Supplement states, in part:

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

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

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

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

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

American Recovery and Reinvestment Act of 2009

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

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

Allowable Costs

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

Davis-Bacon Act

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

Program Income

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

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

Reporting

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

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

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

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

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

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

Procedure L in the Compliance Supplement states,

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

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

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

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

Suggested Audit Procedures – Compliance

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

   a. Financial reports

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

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

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

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

The Los Angeles County Citizen Participation Plan states:

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

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

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

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

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

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

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

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

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

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

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

AU 339.03 states, in part:

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

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

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

Additional Federal Testing Deficiencies

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

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

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

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

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

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

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

- Part 7 of the Compliance Supplement states, in part:

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

OMB Circular A-133 states:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Recommendation

The firm should:

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

Firm's Response

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

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

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

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

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

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

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

AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

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

ALLOWABLE COSTS

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

DAVIS BACON ACT

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

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

PROGRAM INCOME

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

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

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

FINANCIAL REPORTING

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

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

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

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

SPECIAL TESTS AND PROVISIONS

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

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

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

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

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

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

SCO's Comment

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

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

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

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

AU 350.24 states, in part:

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

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

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

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

American Recovery and Reinvestment Act of 2009

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

Allowable Costs

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

Davis-Bacon Act

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

Program Income

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

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

Reporting

Financial Reporting

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

Special Tests and Provisions

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

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

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

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

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

(b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand

the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.

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

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

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

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

Based on our review, we identified the following deficiencies:

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

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

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

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

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

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

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

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

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

Recommendation

The firm should:

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

Firm's Response

CASH DISBURSEMENTS

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

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

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

ELIGIBILITY

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

FINANCIAL REPORTING

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

SCO's Comment

Cash Disbursements

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

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

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

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

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

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

Eligibility

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

Financial Reporting

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

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

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

Noncompliance With Redevelopment Agency Audit Guide Requirements

FINDING 8— Audit documentation and evidence deficiencies

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

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

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

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

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

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

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

AU section 339.10 states, in part:

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

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

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

Recommendation

The firm should comply with audit standards as follows:

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

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