

Firm's Response

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

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

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

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

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

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

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

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

SCO's Comment

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

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

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

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

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

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

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

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

analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.

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

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

**FINDING 9—
Noncompliance with
the Redevelopment
Agency Audit Guide**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Recommendation

The firm should:

- Comply with the RDA Audit Guide and its own audit program when testing for allowable expenditures.
- Test expenditures throughout the audit period so that its audit results can be relied upon.

Firm's Response

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

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

- The State Controller's draft report concluded that our workpapers did not contain documentation that the planning and administrative expenditures were necessary for the production improvement or preservation of low and moderate income housing. We disagree with the SCO conclusion. Our workpapers contained evidence of our examination of the trial balance of the Low and Moderate Income Housing Fund. This review indicated that planning and administrative expenditures of the Low and Moderate Income Housing Fund were not material. Nevertheless, testing was performed and our testing of certain charges to the fund indicated that such charges were for the improvement and preservation of low and moderate income housing. The nature and extent of audit testing is a matter of professional judgment. Our consideration of such testing in this case reflected a reasonable application of professional judgment.
- The State Controller's draft report suggested that trial balances for Fund 22 (low-mod Fund) for the year ended June 30, 2009 which were reviewed by the Audit Engagement Team for the entire year and documented on the trial balances included total expenses for the year audited (including salaries, fringe benefits, supplies and court administrative fee and other minor charges) of \$161,313 for the entire year. Our audit sampling reviewed the documentation of \$14,863 as stated by the SCO (13.16% of expenditures incurred through March 2009 and 9.2% of expenditures incurred for the entire fiscal year). Our review of the trial balance of the Low and Moderate Income Housing Fund indicated that the dollar amount of salaries charged to the fund was not unreasonable in view of the level of effort typically demanded by such funds. Approximately 10% of the salaries of certain personnel were

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

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

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

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

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

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

SCO's Comment

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

- a. The nature, timing, and extent of auditing procedures performed to comply with GAGAS and other applicable standards and requirements;
- b. The results of the audit procedures performed and the audit evidence obtained;
- c. The conclusions reached on significant matters; . . .

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

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

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

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

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

Our finding and recommendation remain unchanged.

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



Mayer Hoffman McCann P.C.

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November 11, 2010

Federal Express - Return Receipt
Requested

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

Dear Mr. Brownfield:

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

SCOPE OF REVIEW

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

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

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



Jeffrey V. Brownfield
Chief, Division of Audits
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DISAGREEMENT WITH SCO DRAFT CONCLUSION

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

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

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

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

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

REQUEST FOR EXIT CONFERENCE

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

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



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

OUR FIRM'S COMMENTS ON SPECIFIC DRAFT FINDINGS

- Finding #1** – Should be deleted in its entirety and a new finding should be drafted to reflect that the Firm had minor instances of documentation deficiencies.
- Finding #2** – This finding should be deleted except for a minor deficiency in documenting our evaluation of the City Charter and our rationale of significant provisions (or the lack thereof) in the Charter.
- Finding #3** – This finding should be deleted in its entirety.
- Finding #4** – This finding should be deleted in its entirety.
- Finding #5** – This finding should be deleted in its entirety.
- Finding #6** – This finding should be redrafted to indicate that deficiencies noted in the audit of Federal Programs contained minor documentation issues.
- Finding #7** – This finding should be deleted in its entirety.
- Finding #8** – This finding should be deleted in its entirety.
- Finding #9** – This finding should be redrafted to indicate that the Firm did not have sufficient evidence of the Agencies' written documentation that planning and administrative expenditures were necessary for the production or improvement of low and moderate housing and that the Firm had other minor documentation issues in its documentation of compliance of more than 80 compliance steps in the SCO Audit Guide.



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

Mayer Hoffman McCann P.C.

MAYER HOFFMAN McCANN P.C.

MAH/kl

Attachments

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



I. EXECUTIVE SUMMARY OF RESPONSE

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

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

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

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

Our workpapers clearly demonstrate that

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



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

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

(1) Audit Documentation And Audit Evidence Were Not Deficient

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

II. BACKGROUND OF REVIEW

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

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

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

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

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

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



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

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

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

III. RESPONSES TO STATE CONTROLLER'S FINDINGS

(1) AUDIT DOCUMENTATION AND AUDIT EVIDENCE WERE NOT DEFICIENT

ANALYTICAL PROCEDURES

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

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

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



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

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

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

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

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

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

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

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



AU 329.22 states:

When an analytical procedure is used as the principle substantive test of a significant statement assertion, the auditor should document all of the following:

- a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed and factors considered in its development [this was documented at workpaper 3-10]
- b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts [this was documented at workpaper 3-10]
- c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedures and the results of such additional procedures [no unexpected differences were identified]

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

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

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

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



CASH AND INVESTMENTS

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

ACCOUNTS RECEIVABLE

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

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

CAPITAL ASSETS

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



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

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



Paragraph 8 of GASB Statement No. 42 indicates:

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

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

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

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

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

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

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



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

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

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

PAYROLL

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

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

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

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



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

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

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

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

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

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



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

The SCO conclusion is correct that our audit program did have a step to identify bonuses or other unusual compensation. As documented at J-0A, our audit staff performed 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 a widely used reference source for the practical application of local government audits.

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



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

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

CONSIDERATION OF CONTRACTS, GRANT AGREEMENTS, LAWS AND REGULATIONS

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

- All Important Agreements, Contract and Debt Provisions, including all Revenue Bond Agreements, Lease Obligations, Concession and other Income Agreements, Pension Plan Information, Joint Powers Authorities, Management Agreements, Important ordinances and resolutions, Notes, Developer Agreements and other important copies of accounting and reporting requirements.
- Our audit documentation demonstrates at workpaper C-1 that our audit tests were designed to test Investment Compliance in accordance with various sections of the California Government Code (Sections 53601 and 53646). These were identified as specific audit risk areas requiring documentation of compliance with the California Government Code.
- Our audit risk assessment also identified debt compliance as a risk area and specific audit tests were documented at workpaper C-6. Official statements in our permanent files were



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

- Our audit documentation and audit program together with an agreed-upon audit procedures report addressed Article XIII B of the State Constitution as an important law to test. Those audit procedures were documented at workpapers S-0, S-1, S-2, S-3 and 1-6.
- Extensive testing of laws and regulations pertaining to federal funding (workpapers SA 1-1.2 through SA LL-4) and redevelopment compliance (workpapers R-0 through S-3) were performed as a part of our audit of the City and Redevelopment Agency.

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



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

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

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

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



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

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

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

Revenue Recognition.

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

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

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

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

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

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

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