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

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

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

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

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

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

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

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

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

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

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

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

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

(4) DOCUMENTATION AND EVALUATION OFSUBSEQUENT EVENTS WAS NOT DEFICIENT

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

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

ALLOWABLE COSTS

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

DAVIS BACON ACT

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

PROGRAM INCOME

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

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

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

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

FINANCIAL REPORTING

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

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

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

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

SPECIAL TESTS AND PROVISIONS

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

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

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

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

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

CASH DISBURSEMENTS

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

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

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

ELIGIBILITY

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

FINANCIAL REPORTING

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ATTACHMENT #10

John Chiang's Letter of Understanding dated 8-2-2010 Regarding City of Bell Quality Control Review

JOHN CHIANG
Controller of the State of California

August 3, 2010

Stephen J. Tully
Garrett & Tully
4165 E. Thousand Oaks Blvd.
Suite 201
Westlake Village, CA 91362

Dear Mr. Tully,

This letter is to confirm my telephone conversation with you on August 2, 2010 regarding a scheduled State Controller's Office (SCO) quality control review of Mayer Hoffman McCann P.C. The entrance conference has been scheduled for August 5, 2010 at 9:00 a.m.

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

As the coordinating agency for single audits of local governments, the SCO may perform quality control reviews of audit working papers to determine whether audits are performed in conformity with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States of America.

We will be reviewing the working papers of Mayer Hoffman McCann P.C.'s audit of the City of Bell for the period July 1, 2008 to June 30, 2009. The planned amount of fieldwork time will be determined based on the documentation available. We will require office space for two reviewers during the fieldwork portion of the review and availability of staff to answer questions.

Our purpose will be to determine if the audit was conducted in accordance with:

- U.S. generally accepted auditing standards (GAAS) and AICPA's professional standards (*Statements on Auditing Standards*).
- *Government Auditing Standards*, issued by the Comptroller General of the United States (GAGAS).
- Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*.
- California *Business and Professions Code*.

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

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

A final report will be issued after the firm has an opportunity to review and respond to the draft report.

Attached is a documentation request. Please have these items available when we begin fieldwork.

If you have any questions please call me at (916) 322-7656.

Sincerely,

Original signed by

CAROLYN BAEZ, CPA
Manager
Financial Audits Bureau
Division of Audits

Attachment

cc: Casandra Moore-Hudnall, Chief
Financial Audits Bureau
Division of Audits

Sunny Okeke, Auditor
Financial Audits Bureau
Division of Audits

Appendix 2—
Firm's December 8, 2010
Additional Response to Draft Review Report

MHM
Mayer Hoffman McCann P.C.
An Independent CPA Firm

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Irvine, California 92612
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www.mhm-pc.com

December 8, 2010

Via Email and Overnight Delivery

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

Dear Mr. Brownfield:

We have previously provided an extensive response to the draft report of the California State Controller's Office (SCO) on the quality control review of Mayer Hoffman McCann P.C.'s (MHM or the Firm) audit workpapers for the City of Bell, California for the year ended June 30, 2009. Rather than repeating all of our responses from our November 11, 2010 correspondence, we incorporate them by reference in this document.

In addition to our summarized comments below, a separate communication dated December 8, 2010 from legal counsel at Garrett & Tully, P.C. representing Mayer Hoffman McCann P.C. is an integral part of our response to the SCO. That communication addresses the conduct of the SCO in the performance of the quality control review.

We believe that our Response dated November 11, 2010, the matters communicated to the SCO in the Exit Conference held on December 3, 2010 and the matters included and referenced in this letter support and require an objective conclusion that –

- **Mayer Hoffman McCann P.C.'s audit was performed in accordance with a majority of the applicable standards and requirements for financial and compliance audits.**

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

We were engaged to perform an audit of the financial statements of the City in accordance with Generally Accepted Auditing Standards and Generally Accepted Government Auditing Standards. The objective of such an engagement is to express an opinion on whether the financial statements are free from material misstatement. That objective is significantly different than a fraud audit which is typically designed to be very narrow and focused in scope (often with the knowledge that a fraud has likely occurred) on a specific risk, account balance or class of transactions, without the concepts of materiality called for in the financial statement auditing standards.

In using a hindsight approach, and having access to the various special investigation fraud audits that have been conducted in 2010 focused on specific activities of the City, the SCO has taken an approach that if a matter was identified in the various special investigation fraud audits, then it automatically is a violation of professional standards, if the financial audit of MHM did not uncover the matter. This is not an appropriate basis for evaluating MHM's compliance with professional standards.

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

During the exit conference, the SCO provided explanations of two of their findings stating that if we had performed an additional test in each of these two areas, the problems identified in the press in 2010 may have been detected. With the benefit of hindsight, the SCO reached the conclusion that we had not complied with professional standards because we had not performed these two additional tests. These two tests are not required by professional standards. They are procedures that an auditor may or may not elect to perform based on his or her risk assessments conducted during planning or as the engagement progresses. Basing a conclusion regarding MHM's compliance with professional standards on the subjective professional judgment, applied using hindsight and with information not available to the engagement team at the time of the audit, of expanding certain audit tests is not appropriate.

GENERAL COMMENTS REGARDING AUDIT DOCUMENTATION

A majority of the comments in the SCO draft report dealt with a single standard, the documentation standard. Although there were certain cases where our documentation of certain audit considerations was not in strict compliance with documentation standards in the Yellow Book and/or Statement on Auditing Standards No. 103, the totality of audit work performed did, in fact, demonstrate –

- The performance of an appropriate mix of audit procedures and testing to support our audit opinion and,
- The compliance with the majority of the professional auditing standards.

Because most of the issues identified by the SCO draft report pertained to the documentation standard, rather than deficiencies in the performance of the audit, the SCO report should acknowledge this by concluding that we complied with the majority of auditing standards.

At the Exit Conference, we requested the SCO provide to Mayer Hoffman McCann P.C. the documentation that supports the SCO's conclusion as to whether a majority of applicable standards and requirements for financial and compliance audits had been met. We did not receive a response. We repeat that request in this letter.

SUPPLEMENTAL INFORMATION

As a supplement to the information provided in our original response to the SCO's draft report, we also provided the following significant information during our exit conference with the SCO on December 3, 2010:

Finding One:

As indicated in our exit conference, we did not rely solely or primarily upon analytical procedures as implied in the SCO draft report with respect to accounts receivable, capital assets, and payroll. Professional auditing standards call for the auditor to use professional judgment in determining the mix of tests to achieve the objective of the financial statement audit.

- For accounts receivable, we also performed tests of controls over the revenue cycle, cut-off tests, and examination of supporting documentation for individually significant components of receivable balances.
- For capital assets, we performed tests of controls and examined support for 36% of current year additions (an unusually high percentage of testing).
- For payroll-related items, we tested internal controls, performed cut-off tests, performed fraud and other inquiries, reviewed receivable support and disbursement transactions (for unrecorded loans), and obtained management representations.

Contracts, Grants, and Laws:

- During our exit conference, we provided a print out of the "dashboard" summary of our electronic audit workpapers that clearly indicated the "integrated" approach that we used to document throughout the audit our consideration of compliance with contracts, grants, and laws. This "dashboard" summary was available to the SCO auditors throughout their quality review, but apparently not considered in the SCO's findings. The print out of this electronic workpaper clearly documented the performance and timing of bond compliance testing (performed in October 2009), investment compliance testing (performed in March 2009), Constitution Article 13B testing (performed in March 2009),

redevelopment compliance testing (performed in March 2009), and grant compliance testing (performed in March 2009).

Finding Three:

- As indicated in our exit conference, there is no evidence to suggest that the City's exercise of an existing contractual right (approved by the city council) to extend debt service on its $35 million bond created substantial doubt about the City's ability to continue as a going concern due to the circumstances of its renewal (to ready the property for its intended use).

Finding Five:

- As indicated in our exit conference, we inquired of outside legal counsel (which constitutes 3rd party audit evidence) of the existence of litigation, claims or other issues and received a response that there were no such matters. We relied on this evidence in determining that no further work was necessary.

Finding Six:

- As indicated in our exit conference, program income regulations only apply when program income exceeds $25,000. Because the City's income did not meet that threshold, the regulation is not applicable.
- As indicated in our exit conference, Federal Form SF-272 is not applicable to subrecipient agencies such as the City of Bell.

Finding Eight:

During our exit conference, we provided the following information regarding the redevelopment agency's placement on the state's "sanctions" list:

- The agency was placed on the sanction list during the fiscal year after the end of the audit period covered by our audit report (July 7, 2009)
- The agency's placement on the sanction list was based on an issue of dispute (subsequently resolved and cured between the parties) involving $63,766.
- This issue of dispute between the parties was not "direct and material to the determination of financial statement amounts" for the year ended June 30, 2009.
- This subsequent event (placement on the sanction list after the balance sheet date) was not truthfully responded to by the City in response to our inquires regarding subsequent events
- The City's written representations in the representation letter omitted the Agency's status with respect to the sanction list.
- The third party attorney letter omitted the Agency's status with respect to the sanction list.

- The Agency's placement on the sanction list was temporary and the Agency is currently not on the sanction list.

We will continue to cooperate with all parties in the regulatory and law enforcement agencies.

Mayer Hoffman McCann P.C.

MAYER HOFFMAN McCANN P.C.

Attachment
1. Garrett & Tully, P.C. Letter dated December 8, 2010

Appendix 3—
Firm's December 18, 2010 Letters

MHM
Mayer Hoffman McCann P.C.
An Independent CPA Firm

11440 Tomahawk Creek Parkway
Leawood, Kansas 66211
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913-234-1100 fx
www.mhm-pc.com

December 18, 2010

Via Email and Overnight Delivery

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

Dear Mr. Brownfield:

In our letter dated December 8, 2010, we referenced a correspondence dated December 8, 2010 from legal counsel at Garrett & Tully, P.C. as an integral part of our response to the California State Controller's Office (SCO) on the quality control review of our workpapers for the City of Bell, California. Mayer Hoffman McCann P.C. is committed to the renewed efforts of the firm and the SCO to work together in pursuit of the facts and resolution of the issues the review has raised. The claims in counsel's December 8 letter, as well as the request for investigation, are therefore withdrawn. MHM specifically withdraws comments or inferences in the letter concerning the intentions or motivations of the SCO, based on communications we have since had with the SCO, and the expectation of further discussions regarding this and other issues raised by the review. Additionally, the request for documentation/PRA by Garrett & Tully is withdrawn. Accordingly, our reference to the Garrett & Tully, P.C. correspondence dated December 8, 2010 should be removed from our response.

Thank you.

Mayer Hoffman McCann P.C.

MHM
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An Independent CPA Firm

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December 18, 2010

Via Email and Overnight Delivery

John Chiang
Jeffrey V. Brownfield
Cassandra Moore-Hudnall
California State Controller's Office
3301 C. Street, Suite 700
Sacramento, California 95816

Gentlepersons:

As requested by the SCO, we are providing new information at this time with respect to the report of the California State Controller's Office (SCO) on the quality control review of Mayer Hoffman McCann P.C.'s audit workpapers for the City of Bell, California for the year ended June 30, 2009.

During the conduct of this review, Mayer Hoffman McCann P.C. engaged legal counsel to assist us in the coordination of the review. Our legal counsel inquired during the review whether the SCO had questions or wished to talk with Mayer Hoffman McCann P.C. auditors directly, and was told that the SCO was comfortable with the line of communication through counsel. We now understand that SCO auditors usually meet with and conduct interviews with the audit team that worked on the engagement as a standard procedure. We encourage that the SCO follow its standard protocol and we will make our key personnel on the audit team available to meet with the SCO representatives.

The new information that we believe the SCO auditors will receive from such meetings is to learn first-hand from those individuals who interacted with City employees and officials the extent of the massive collusion involving City employees and officials that has been revealed in press reports and the SCO's additional investigations subsequent to our June 30, 2009 audit engagement. Such collusion appears to have been systemic with the intent to circumvent the City's fraud prevention polices and to deceive the auditors in the performance of their duties. We believe this new information raises significant issues that certainly relate to the purpose and propriety of the procedures employed in the audit under review, but also more generally to profession-wide concerns about the risk of collusion in a financial statement audit and the standards currently utilized to address that risk.

In addition, Mayer Hoffman McCann P.C. has given considerable thought into recommendations to prevent the events of the City of Bell from ever occurring again in the future. We would appreciate the opportunity to share our suggestions and work together with the SCO in future to enhance procedures for more transparent and robust financial reporting and disclosures, improved governance, as well as improved audit standards and furthering the mission of the SCO. We are prepared to offer over a dozen of new audit, oversight and governance procedures for consideration.

Thank you for your consideration of this request.

Mayer Hoffman McCann P.C.

State Controller's Office
Division of Audits
Post Office Box 942850
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http://www.sco.ca.gov