

Audit Best Practices for Detecting and Curtailing Charter School Fraud

**Multi-Agency
Charter School
Audits Task Force**

September 2024





MALIA M. COHEN
CALIFORNIA STATE CONTROLLER

September 25, 2024

To Whom It May Concern:

It is an honor to serve as the Chair of the Charter School Audits Task Force (Task Force) for purposes of developing recommendations for best practices as well as audit criteria designed to detect and curtail fraud in charter schools at the earliest possible time. Taxpayers demand the accountability and transparency in the charter school sector to ensure education funds benefit students and not those that are intent on perpetuating a fraud through an elaborate scheme designed to avoid detection.

California has a diverse public school system responsible for the education of more than six million children and young adults in more than 10,000 schools, with more than 300,000 teachers. Additionally, California has approximately 1,300 charter schools. With the education of our children at stake and significant state investments of taxpayer money in education, it is crucial that all schools be held to the highest level of integrity, accountability, fiscal compliance, and transparency to make certain to the extent possible that students receive the educational resources and opportunities that were intended for them and to support success.

The Task Force met monthly to discuss various topics related to charter school accountability, transparency, oversight, and audit functions to identify best practices and recommendations. The diligence and commitment of the Task Force to achieve the objectives and goals set forth by the court has culminated into the enclosed report.

While the Task Force focused primarily on charter school audit functions, most of the recommendations will apply to all local education agencies, including school districts, county offices of education, and charter schools, and, in that regard, provides opportunities by my office to strengthen audit oversight throughout the K-12 education system.

It is imperative that we implement the Task Force recommendations to encourage sound fiscal management among local educational agencies, including charter schools, for the most efficient and effective use of public funds for the education of children in California by strengthening fiscal accountability at the school district, county, and state levels.

As the Constitutional Officer tasked with ensuring that school districts are audited and held fully accountable for safeguarding dollars appropriated for purposes of educating students, I extend my gratitude to San Diego Superior Court Judge Robert Longstreth, San Diego District Attorney Summer Stephan, and Successor Receiver William Robert Ayres for having the foresight to require this Task Force. I also extend my appreciation to each Task Force member for their collective

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and individual contributions to this report

If you have any questions regarding this report, please contact Kimberly Tarvin, Chief, Division of Audits at (916) 324-7226. Thank you

Sincerely,

A handwritten signature in blue ink that reads "Malia Cohen". The signature is written in a cursive, flowing style.

Malia M. Cohen

California State Controller

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ACKNOWLEDGEMENTS

We express our appreciation to each of the Charter School Audits Task Force (Task Force) members including the Task Force Chair, leading parties, key contributor, primary and alternate members, and facilitators for their commitment to enhancing the charter school audit functions to timely detect and curtail fraud. The collaborative, in-depth discussions of the Task Force members and combined multi-disciplinary knowledge, expertise, and experience in the charter school sector resulted in the recommendations in this report. These recommendations are intended to enhance the charter school audit functions, foster a culture of transparency and accountability, and promote trust and confidence in the oversight of California charter schools.

Task Force Leading Parties

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Task Force Facilitation

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Task Force Primary and Alternate Members

Organization	Primary Members	Alternate Members
California Association of School Business Officials	Tatia Davenport Chief Executive Officer	Molly Schlange Past President
California Charter Schools Association	Ricardo Soto Chief Advocacy Officer and General Counsel	Colin Miller Vice President, Government Affairs
California County Superintendents	Michael Simonson Deputy Superintendent, San Diego County Office of Education	Misty Key Deputy Superintendent Fiscal and Administrative Services Ventura County Office of Education
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ABBREVIATIONS USED IN THIS REPORT

AICPA	American Institute of Certified Public Accountants
A3	Academics Arts and Action Education
CBA	California Board of Accountancy
CDE	California Department of Education
CMO	Charter Management Organization
CPA	Certified Public Accountant
CPADS	Certified Public Accountants Directory Service
EAAP	Education Audit Appeals Panel
FCMAT	Fiscal Crisis & Management Assistance Team
FY	Fiscal Year
GAAS	Generally Accepted Auditing Standards
GAGAS	Generally Accepted Government Auditing Standards
K-12 Audit Guide	Guide for Annual Audits of K-12 Local Education Agencies and State Compliance Reporting
LEA	Local Education Agency
MOU	Memorandum of Understanding
SBE	State Board of Education
SCO	State Controller's Office
Task Force	Multi-Agency Charter School Audits Task Force

SUMMARY

The Multi-Agency Charter School Audits Task Force's primary objective is to examine the audit functions of the California charter schools and develop comprehensive guidelines that will assist charter school authorizers, county offices of education, California Department of Education, and State Controller's Office to promptly identify financial issues or misconduct.

In 2019, the San Diego District Attorney's Office prosecuted 11 individuals associated with the Academics Arts and Action Education network of 19 charter schools. The 11 individuals perpetrated a complicated scheme intended to defraud California families and the State of California, representing the largest fraud in California's 31-year history of charter schools. The fraud involved falsely enrolling students, manipulating enrollment figures, and funneling funds into companies controlled by Sean McManus and Jason Schrock. Over a several-year period, this fraudulent operation brought in approximately \$400 million in revenue. In addition to this scheme, other California charter school frauds have been uncovered in recent years that included illegal, wasteful, and fraudulent expenditures.

In response to the Academics Arts and Action Education fraud case, San Diego Superior Court Judge Robert C. Longstreth signed a court order on September 21, 2023, granting a motion to approve the formation of a multi-agency task force, known as the Multi-Agency Charter School Audits Task Force (Task Force), to combat charter school fraud. The San Diego Superior Court order incorporated a Memorandum of Understanding that established the Task Force's purpose, membership, goals, confidentiality requirements, and reporting requirements, among other terms and conditions.

The Task Force extensively discussed the current state of California charter schools and developed recommendations based on the combined expertise, experience, and knowledge of multi-disciplinary Task Force members. These recommendations are intended to foster a culture of transparency and accountability by further strengthening charter school audit function components. The recommendations are organized into the following sections of this report:

- Certified Public Accountant Firm Authorization, Qualifications, Training, Evaluation, and Compliance with K-12 Audit Guide
- Certified Public Accountant Firm Selection, Rotation, and Late Audit Report Notifications
- K-12 Audit Guide Procedures
- Financial Statement Audit Report Disclosures

The Task Force determined that most of the recommendations should be applied to all local education agencies including school districts, county offices of education, and charter schools, providing opportunities to strengthen the audit functions across the entire local education agency system.

To combat fraud in charter schools, it is important that oversight agencies, in addition to those performing charter school audit functions, implement strong internal and monitoring controls to timely identify and mitigate potential fraud. The control and monitoring functions include the charter school petition and approval process, the charter school accountability systems, the authorizer monitoring of charter schools, and the respective oversight functions of the charter school governing board, county offices of education, the California Department of Education, and the State Controller's Office.

BACKGROUND

Multi-Agency Charter School Audits Task Force

In 2019, the San Diego District Attorney's Office prosecuted 11 individuals associated with the Academics Arts and Action Education (A3) network of 19 charter schools. The 11 individuals perpetrated the largest fraud in California's 31-year history of charter schools. Over several years, this fraudulent operation brought in approximately \$400 million in revenue. In addition to the A3 fraud, other California charter school frauds have been uncovered in recent years that included illegal, wasteful, and fraudulent expenditures.

To commit the fraud, the A3 network required the parents of student athletes to sign master agreements that enrolled the students in an A3 charter school, even though the athletes were not provided educational services. A3 also recruited students from private schools and other programs; and required the completion of master agreements which enrolled the students in an A3 charter school, even though these students continued to attend their private schools and/or participate in other programs. The A3 enrollment staff was paid commission for enrolling students and a portion of the funds was paid to the athletic program, private school, or other student program as an incentive to receive the signed master agreements. The fraudulently obtained public-school funding was funneled into companies owned by Sean McManus and Jason Schrock.

On September 21, 2023, the San Diego Superior Court Judge Robert C. Longstreth signed a court order granting a motion to approve the formation of a multi-agency task force, known as the Multi-Agency Charter School Audits Task Force (Task Force), to combat charter school fraud. The San Diego Superior Court order incorporated a Memorandum of Understanding (MOU) that established the Task Force purpose, membership, goals, confidentiality requirements, and reporting requirements, among other terms and conditions.

The MOU designated the California State Controller as the Task Force Chair, with the leading member agencies including the California State Controller's Office (SCO), the Successor Receiver and his representative, and the San Diego District Attorney's Office. Additionally, the MOU designated various member organizations, listed on pages 1 and 2, to participate in the Task Force.

The primary objective of the Task Force is to examine the audit functions of the California charter schools and develop comprehensive guidelines to assist the authorizers, the county offices of education, the California Department of Education (CDE), and the SCO to promptly identify financial issues or misconduct. The MOU prescribed the goals listed below:

TASK FORCE GOALS

- A** Evaluate the system for authorizing auditors and review the required qualifications for serving in this function.
- B** Review the protocol for training and evaluating authorized auditors.
- C** Evaluate the compliance of authorized auditors conducting reviews of California Charter schools with the *Guide for Annual Audits of K-12 Local Education Agencies and State Compliance Reporting*.
- D** Develop guidelines and requirements, including notification requirements, for the charter school and the auditor in the event of auditor termination or replacement by a charter school.
- E** Identify best practices and recommendations for the improvement of the audit process for California charter schools.
- F** Identify potential legal or regulatory obstacles to the implementation of the recommendations, and provide guidance for overcoming such obstacles.
- G** Provide timely and accurate information on the state of California charter schools, including compliance issues, areas for improvement, and best practices.
- H** Foster a culture of transparency and accountability in auditing operations, and promote trust and confidence in the oversight of California charter schools.

Charter School Oversight Structure

Charter schools are publicly funded elementary and secondary schools operating under charter agreements approved by authorizing school districts or county boards of education and are subject to various Education Code requirements. Charter schools were created to offer parents or guardians an alternative to traditional public schools. The Charter School Act established publicly funded charter schools in 1992. Since then, the number of charter schools in California has grown to approximately 1,300.

To become a charter school, a proposed charter school must submit a petition for the establishment of a charter school to an “authorizer” requesting approval of the charter school petition. Most authorizers are either the school district or the county board of education in which the charter plans to operate; however, a few charter schools are still overseen by the California State Board of Education (SBE). A charter school is established upon approval by the authorizer of the proposed charter, in accordance with requirements in the California Education Code. Authorizers are responsible for ongoing oversight and monitoring of the charter schools they authorized in accordance with Education Code requirements. At a minimum, each authorizer must fulfill five basic responsibilities: 1) identify a contact person at the charter school; 2) visit the charter school at least annually; 3) ensure the charter school completes all required reports, including the Local Control and Accountability Plan; 4) monitor the charter school’s finances; and 5) notify SBE if a charter is renewed, revoked, or the school closes.

County offices of education oversee school districts to ensure that school districts are fulfilling their responsibilities as charter school authorizers. In accordance with Education Code 1241.5, a county superintendent may review or audit the expenditures or internal controls of any charter school in his or her county if he or she has reason to believe that fraud, misappropriation of funds, or other illegal fiscal practices have occurred that merit examination.

CDE provides oversight, guidance, and resources to assist various stakeholders and those charged with oversight, auditing, and operational roles in the educational system. Due to the local control structure of California’s education system, direct oversight of charter schools is generally delegated to the county boards of education and school districts that authorize the charter schools.

The SCO conducts various oversight and monitoring functions in accordance with the Education Code requirements. The SCO maintains a directory of Certified Public Accountant (CPA) firms that are authorized to perform annual financial statement and compliance audits of LEAs, which include school districts, county offices of education, and charter schools. Additionally, the SCO reviews each LEA's annual financial statement and compliance audit report and certifies that the report complies with professional audit reporting standards and the K-12 Audit Guide. The SCO also conducts quality-control reviews of the CPA firms that conduct these audits. Further, the SCO performs periodic reviews of the county offices of education to ensure that they are resolving audit findings disclosed in the annual financial and compliance audit reports. In addition, the SCO facilitates the working group that annually updates the *Guide for Annual Audits of K-12 Local Education Agencies and State Compliance Reporting* (K-12 Audit Guide) that CPAs must use in the performance of the annual financial statement and compliance audit. The proposed K-12 Audit Guide revisions are submitted to the Education Audit Appeals Panel (EAAP) and are annually adopted during a public meeting in accordance with required regulatory rulemaking processes.

The Fiscal Crisis and Management Assistance Team (FCMAT) is a state agency that contributes to the accountability and transparency of LEAs, including charter schools. FCMAT's primary mission is to help California's LEAs identify, prevent, and resolve financial, operational, and data management challenges by providing management assistance and professional learning opportunities. FCMAT generally divides its services into five categories: 1) management assistance, 2) professional learning and product development, 3) fraud reviews, 4) fiscal crisis management, and 5) data management.

Other professional educational organizations provide various support activities such as conferences, tools and templates, workgroup opportunities, and various other resources for educational entities. Several of these organizations participated in the workgroup, as indicated on page 2 of this report. Each of these organizations shares on its website its mission, strategies, and resources to support and strengthen various aspects of the educational system.

Local Education Agency Compliance

The SCO compiles the audit report findings published in the LEA annual financial statement and compliance audits conducted by CPAs and submitted to the SCO. The tables below display the number of audit report findings by category for the last three fiscal years (FY) for charter schools.

Charter Schools Audit Report Findings by Fiscal Year

Audit Finding Report Categories	2022-23	2021-22	2020-21
Internal Controls	57	54	66
Average Daily Attendance	14	15	0
Attendance	36	53	23
Federal Programs	11	7	5
State Compliance	119	122	35
TOTAL	237	251	129

The number of findings in FY 2022-23 are significantly lower than the previous year due to missing data. As of April 2023, the SCO has not yet received all of the annual financial statement and compliance audit reports. The increase in audit findings from FY 2020-21 to FY 2021-22 are primarily due to increases in the following four compliance areas:

- attendance reporting (increase in audit findings due to COVID related issues).
- independent study contracts not including all required elements (increase due to new elements that were added in FY 2021-22).
- After School Education and Safety Program (increase because CPAs were not required to audit the program in FY 2020-21).
- Expanded Learning Opportunities Grant (increase in findings because this was a new grant program in FY 2021-22).

Certified Public Accountant Compliance with Audit Report Requirements

The SCO reviews and certifies the LEA annual financial statement and compliance audit reports conducted by CPAs and submitted to the SCO in accordance with Education Code Section 14505. The certification process evaluates whether each LEA’s annual financial statement and compliance audit report complies with professional audit reporting standards and the K-12 Audit Guide requirements. The SCO requires the CPA to correct report deficiencies. The SCO’s audit report certification reviews identified the charter school financial statement and compliance audit report deficiencies presented below by category for the last three fiscal years.

Charter Schools Audit Report Deficiencies by Fiscal Year

Audit Report Deficiency Categories	2022-23	2021-22	2020-21
Auditor’s Report on the Financial Statements	37	53	28
Basic Financial Statements	4	1	5
Notes to the Financial Statements	12	6	13
Supplementary Information Section	45	24	25
Report on Compliance for Each Major Federal Program	8	12	10
Schedule of Expenditures of Federal Awards	9	17	11
Report on Internal Control Over Financial Reporting	83	47	87
State Compliance Report	76	164	137
Findings and Recommendations Section	31	24	21
Other	3	0	2
TOTAL	308	348	339

The number of deficiencies for FY 2022-23 are lower than previous years due to missing data. As of April 2023, the SCO has not received all of the annual financial statement and compliance audit reports for FY 2022-23. The number of deficiencies for the State Compliance Reports and the Auditor's Report on the Financial Statements increased from FY 2020-21 to FY 2021-22 because some auditors did not update the audit report language to comply with new audit reporting standards.

METHODOLOGY

Task Force Structure

The SCO convened the Task Force members in accordance with the requirements established in the court-approved MOU. The combined members of the Task Force comprise an exceptional, broad-based, multi-disciplinary team with in-depth expertise and extensive experience in LEA administration and oversight. To ensure a quorum for Task Force meetings, each member designated an alternate member to attend meetings and act in the primary member’s absence. The Task Force member organizations and participants are identified on pages 1 and 2 of this report.

Task Force Meetings

The Task Force members held eight monthly three-hour meetings from November 2023 through June 2024, as follows:

Monthly Meetings	Discussion
November 2023	The Task Force held the kick-off meeting and discussed the current state of California charter schools. Task Force members were provided confidential information about the A3 case to provide context for future discussions.
December 2023 through March 2024	Task Force members discussed various LEA and charter school topics and identified potential recommendations consistent with the goals outlined in the MOU.
April and May 2024	Task Force members discussed the Task Force draft report structure and obtained general consensus for most of the proposed report recommendations.
June 2024	The Task Force draft report was discussed and adopted by the Task Force members. The final report was submitted to the presiding judge, Robert C. Longstreth, in <i>In re McManus</i> , Case No. SCD266439, San Diego Superior Court, the California Department of Education, and each of the agencies participating in the Task Force.

REPORT STRUCTURE ALIGNMENT WITH MEMORANDUM OF UNDERSTANDING GOALS

Task Force members discussed the current state of charter schools, current requirements and processes, and potential fraud risks; and identified various recommendations to strengthen the charter school audit functions in accordance with the goals specified in the MOU. The Task Force concluded that most of the recommendations would benefit all LEAs, including school districts, county offices of education, and charter schools. The sections in this report align with the MOU Goals as follows:

- CPA Firm Authorization, Qualifications, Training, Evaluation, and Compliance with K-12 Audit Guide. (Goals A, B, and C)
- LEA Notifications for CPA Firm Selection and Rotation. (Goal D)
- Audit Process Best Practices. (Goal E)
- Potential Obstacles and Solutions. (Goal F)
- The current state of California charter schools is addressed throughout this report. The Background section of this report provides information about charter school audit report findings and CPA audit report deficiencies for the last three years. In addition, various sections of this report discuss charter school oversight processes and responsibilities. (Goal G)
- The areas for improvement and best practices are incorporated into the recommendations. Implementation of the recommendations and best practices will foster a culture of transparency and accountability in auditing operations and are intended to promote trust and confidence in the oversight of California charter schools. (Goal H)

CERTIFIED PUBLIC ACCOUNTANT FIRM AUTHORIZATION, QUALIFICATIONS, TRAINING, EVALUATION, AND COMPLIANCE WITH K-12 AUDIT GUIDE

CPA firms must be approved by the SCO in order to conduct annual financial statement and compliance audits of local education agencies, including school districts, county offices of education, and charter schools. CPAs and the audits they perform are regulated by the California Education Code, the California Business and Professions Code, generally accepted auditing standards (GAAS), and generally accepted government auditing standards (GAGAS). The Board of Accountancy has the authority and oversight of all CPAs practicing in California. To support interstate commerce and mobility of the accounting industry, all states in the United States, including California, substantially conform to the American Institute of Certified Public Accountants standards for licensing, continuing education, and peer reviews.

California Board of Accountancy – Individual Certified Public Accountant License Requirements

CPAs are licensed and regulated by the California Board of Accountancy (CBA). License requirements for an individual to perform audit engagements include:

- Bachelor's degree, including 150 total semester units comprised of 24 units of accounting subjects, 24 units of business-related subjects, 20 units of accounting study, and 10 units of ethics study.
- Pass the Uniform CPA Exam.
- 12 months of experience in accordance with applicable professional standards under the supervision of an individual holding an active CPA license.
- A minimum of 500 hours performing attest engagements under the supervision of a CPA (for attest licensure).
- State/federal fingerprint clearance.

Although the CBA requires individuals to meet education and experience requirements, it does not require any experience and training directly related to the performance of specific types of audits, including LEA and/or charter school audits.

California Board of Accountancy – Corporate and Partnership License Requirements

CPA corporations and partnerships are licensed and regulated by the CBA. License requirements for CPA firms to perform audit engagements include:

- CPA Firm Ownership—The majority of the shareholders/partners (over 50 percent) must be licensed CPAs.
- Liability Protections to Clients—Corporate-structured CPA firms are required by California Code of Regulations, Title 16, Division 1, Article 11, section 75.8 to provide security for claims against it by its clients arising out of the rendering of, or failure to render, professional services by either:
 - maintaining a required level of professional liability insurance; or
 - providing a written agreement of the shareholders that they shall jointly and severally guarantee payment for claims against the accountancy corporation.

Continuing Education Requirements

CPAs are required to meet the CBA's continuing education requirements as a condition of their CPA license renewals. CPAs conducting audits of LEAs must also meet the continuing professional education requirements of the GAGAS, issued by the federal Government Accountability Office. The CBA does not require CPAs to report compliance with GAGAS; however, compliance with training requirements is assessed during the CPA's peer review.

The main difference between the CBA's continuing education requirement and the GAGAS requirement is that the CBA requires and enforces training only for licensed CPAs, while GAGAS requires training for all audit team members, including non-CPAs. Both the CBA and GAGAS require 80 hours of training every two years; however, neither require a minimum amount of training specifically related to accounting, auditing, or compliance requirements for LEAs, including school districts, county offices of education, or charter schools.

The auditing standards require that CPAs only accept engagements that they are competent to perform, and training assists the audit team in obtaining and maintaining competence. A comparison of the continuing education requirements that apply to CPAs and auditors conducting LEA audits is presented below.

Continuing Professional Education Requirements Comparison

Training Requirement	California Board of Accountancy	Generally Accepted Government Auditing Standards
Applicability	CPAs only	CPAs and non-CPAs that plan, direct, and perform GAGAS audits
80 hours every two years	Yes	Yes
Minimum 20 hours each year	Yes	Yes
Minimum 12 hours in technical subject matter each year	Yes	No
Ethics – four hours	Yes	No
Regulatory Review – two hours every six years	Yes	No
Fraud – four hours	Yes	No
Accounting and Auditing – 24 Hours (If conducting nongovernment audits)	Yes	Incorporated into government accounting and auditing requirements below
Government Accounting and Auditing – 24 hours (If conducting government audits)	Yes	Yes

State Controller's Office – Certified Public Accountants Directory Service

LEAs may not contract with a CPA to perform their annual financial and compliance audits unless the CPA is approved by the SCO and listed on the SCO's Certified Public Accountants Directory Service (CPADS) in accordance with Education Code 41020(f)(1). The SCO's CPADS listing is maintained on the SCO's website at https://sco.ca.gov/aud_k12_lea.html.

During FY 2021-22, CPADS included 57 CPA firms authorized to conduct LEA audits. However, only 47 of the 57 CPA firms conducted LEA audits for FY 2021-22. As of November 2023, the SCO received 2,276 FY 2021-22 financial statement and compliance audit reports, including those of 58 county offices of education, 940 school districts, and 1,278 charter schools. For the audits completed:

- One CPA firm conducted 429 audits, comprised of 275 non-charter school audits and 154 charter school audits.
- 10 CPA firms conducted 50 or more audits, representing 76 percent of total LEA audits and 77 percent of the charter school audits.
- 22 CPA firms each conducted 20 or more audits, representing 93 percent of all of the audits.
- 17 firms conducted less than 5 audits.

The statistical data above shows that a small number of firms conduct the majority of the total LEA financial statement and compliance audits in California. With 22 firms conducting 93 percent of the LEA audits, the poor performance of any one CPA firm may significantly impact the quality and reliability of the LEA audits. Additionally, the 17 CPA firms that conduct very few audits (less than five annually) may have less experience conducting LEA audits than other firms that conduct significantly more audits every year.

The CBA's website lists approximately 65,000 individual CPAs and 6,571 CPA firms that are actively licensed in California. Therefore, the CPA firms that conduct audits of LEAs, including charter schools, represent less than .01 percent (47/6,571) of the total CPA firms licensed in California.

Authorization Requirements to Conduct Local Education Agency Audits

CPAs and CPA firms must submit to the SCO a written request to be added to CPADS, which lists CPA firms certified as being in good standing by the CBA and authorized to conduct LEA audits. The SCO's CPADS webpage states that the SCO does not endorse any particular firm, nor does it provide any assurances or guarantees regarding the quality or accuracy of the services provided by the CPA firms listed.

Education Code section 41020(f)(3) states that the SCO shall use the following criteria to determine whether CPAs should be included in the directory:

- The CPA shall be in good standing as certified by the CBA.
- The CPA, as a result of a quality control review conducted by the Controller pursuant to Education Code section 14504.2, shall not have been found to have conducted an audit in a manner constituting noncompliance with subdivision (a) of Education Code section 14503.

The Education Code does not specify other criteria, such as a minimum level of experience and training, for consideration regarding whether a CPA should be added to the directory.

Certified Public Accountant Evaluation and Compliance with the K-12 Audit Guide

The SCO conducts a limited number of quality control reviews of CPAs that conduct annual financial statement and compliance audits of school districts and/or charter schools. The SCO's quality control reviews evaluate whether the CPA performed the audit in accordance with applicable auditing standards and performed state compliance audit procedures in accordance with the K-12 Audit Guide. The quality control reviews also determine whether the CPA firm complied with training and peer review requirements.

Education Code Section 14504.2(a) provides that the SCO **may** perform quality control reviews of the CPA's LEA audit working papers, including charter school audits. Further, SCO

must perform a quality control review of CPAs who performed audits of LEAs if any one of the following three circumstances exists:

- The LEA received an emergency apportionment pursuant to Education Code section 41320 et. sec. or Education Code section 41325 et. sec.
- The budget of the LEA is disapproved, or the LEA received a negative certification on any budget or interim financial report, as defined in Education Code section 42131, during the current or preceding fiscal year.
- The responsible county superintendent of schools otherwise determined that a lack of going concern exists for a LEA pursuant to Education Code Section 42127.6.

The above three criteria do not apply to charter schools; therefore, the SCO is not required to perform quality control reviews of charter school audits. The first criteria does not apply to charter schools because charter schools are not eligible to receive emergency apportionment loans and are not covered by the state receivership statutes. The second criteria does not apply to charter schools because the Education Code does not require charter school budgets to be approved and certified. The third requirement applies only to school districts based on the plain language of the Education Code. Additionally, there is no requirement that a quality control review must be conducted within any timeframe once a CPA begins conducting LEA audits or after a significant break in conducting LEA audits.

California Board of Accountancy Oversight and Regulation of Certified Public Accountants

The CBA does not have regulatory requirements specific to CPAs that perform LEA or charter school audits. However, the CBA regulates all CPAs using the following methods:

- Initial CPA licensure.
- CPA renewal processes, including continuing professional development reporting.
- Peer reviews required every three years.

- Investigations (usually in response to public/client complaints).
- CPA self-reporting requirements—CPAs must self-report to CBA if they commit crimes or are sued for negligence related to their license activities.

The CBA may take disciplinary actions including imposing fine/penalties, requiring additional training, and suspending or permanently revoking the CPA's license.

Certified Public Accountant Removal from the Certified Public Accountants Directory Service

CPAs removed from the SCO's CPADS are no longer authorized to perform audits of LEAs including charter schools. Education Code sections 14504.2 and 41020.5 prescribe two pathways for CPA removal from CPADS for a period of three years as follows:

- If the SCO's quality control review of the CPA determines that the audit was conducted in a manner that may constitute unprofessional conduct, as defined in Business and Professions Code section 5100 including, but not limited to, gross negligence resulting in a material misstatement in the audit. Upon this determination, the Controller shall refer the case to the CBA. (Education Code section 14504.2(c)(2)).
- If a county superintendent of schools determines, or the Controller determines by two consecutive quality control reviews conducted pursuant to Education Code Section 14504.2, that the audits performed by a CPA were not performed in substantial conformity with provisions of the audit guide or that the reports--including amended reports--submitted by February 15 following the close of the fiscal year audited for two consecutive years, do not conform to the provisions of the audit guide. (Education Code Section 14504).

Additional details are provided in the table below.

Education Code Criteria Regarding Certified Public Accountant Removal from the Certified Public Accountants Directory Service

Components	Education Code 14504.2	Education Code 41020.5
Removal Criteria	Unprofessional conduct including gross negligence (may be determined based on one quality control review)	Failure to follow audit standards and/or the K-12 Audit Guide. Removal must be based on two consecutive negative quality control reviews
Number of Reviews	One negative quality control review	Two consecutive negative quality control reviews
Determined By	SCO or the county superintendent	SCO or the county superintendent
Removal Timing	Immediate, but CPA may appeal decision to the CBA	Removal after 30-day appeal period expires or upon final determination of the CBA if the CPA appeals
Maximum Removal Period	Three Years	Three Years

California Board of Accountancy Peer Review Requirement

A peer review is a study of a CPA or CPA firm’s accounting and auditing work, by an unaffiliated CPA following professional standards. The CBA regulates and enforces CPA peer review requirements. CPA firms and CPAs practicing as sole proprietorships are required to undergo a peer review every three years if they are engaged in performing audits. CPAs must comply with peer review requirements prior to renewing their licenses.

Peer reviews may be performed only through a CBA-recognized peer review program. Presently, only the American Institute for Certified Public Accountants (AICPA) is recognized by the CBA with the authority to administer peer reviews. The AICPA uses several administering entities nationally to administer its peer review program. In California, the California Society of CPAs is the administering entity for the AICPA Peer Review Program.

CPAs that receive a positive peer-review rating of “pass”, or “pass with deficiencies”, are not required to submit their peer-review reports to the CBA. CPA firms and individual CPAs that receive a substandard peer review rating are required to submit their peer review reports to the CBA within 45 days of report issuance. GAGAS requires that all peer review reports be publicly available.

According to the AICPA Peer Review Program, CPAs that perform audits are required to have a system-type quality control review. A system review includes assessing the CPA’s overall performance and controls, and includes, but is not limited to, the following review procedures:

- Interviewing firm personnel.
- Examining CPE records.
- Examining outside consultations regarding accounting and auditing matters.
- Examining independence representations.
- Reviewing a reasonable cross-section of the firm’s engagements with a focus on high-risk engagements and significant audit quality risk areas.

The peer reviewers are not required to have experience conducting LEA financial statement and compliance audits. Additionally, the peer review engagements selected for review may or may not include an audit of a school district, county office of education, or charter school. As a result, there is no assurance that the peer review will assess the quality of the LEA audits. To better use the CBA’s peer review process to increase assurance of the quality and reliability of LEA audits, peer reviewers for CPAs that conduct LEA financial statement and compliance audits should have experience auditing LEAs and be mandated to select at least one LEA audit engagement for peer review.

Recommendations

Task Force members discussed the current structure and best practices for CPA firm authorization, qualifications, training, evaluation, and compliance with the K-12 Audit Guide. To build upon and enhance best practices already implemented, the Task Force provides the recommendations displayed in the following table:

Certified Public Accountant Authorization, Qualifications, Training, Evaluation, and K-12 Audit Guide Compliance Recommendations

Number	Competency	Recommendation
A1	Enhance CPA Training and Authorization Requirements	<p>To ensure that CPA firms and their staff acquire and maintain LEA-specific knowledge and expertise critical to ensuring high-quality LEA financial statement and compliance audits, we recommend the following:</p> <ol style="list-style-type: none"> A. CPA firms and their audit staff conducting the LEA financial statement and compliance audits complete 24 hours of LEA-specific training before authorization of the CPA firm in SCO's CPADS. B. Require CPA firms and their staff to complete 24 hours of LEA-specific training every two years on an ongoing basis to retain authorization to conduct financial statement and compliance audits of LEAs in CPADS. C. Require the CPA firms to certify to the SCO that the CPA firm and its auditors conducting financial statement and compliance audits of LEAs have: <ul style="list-style-type: none"> • Met or exceeded the training requirements above. • Prior experience conducting LEA annual financial statement and compliance audits or have gained the necessary competence through training or other professional development activities in accordance with GAAS and GAGAS prior to conducting LEA annual financial statement and compliance audits.

Number	Competency	Recommendation
A2	LEA-Specific Training Topics	<p>Convene a broad-based workgroup to recommend to the SCO LEA-specific training topics that satisfy the 24 hours of continuing professional development requirement. Potential training topics identified by the Task Force include, but are not limited to, the following:</p> <ul style="list-style-type: none"> • LEA fraud risks • Auditor independence • Professional skepticism • Sampling techniques • School accounting • Enrollment and attendance • K-12 Audit Guide
A3	Evaluation and Compliance with K-12 Guide	<p>Revise the Education Code to require additional quality control reviews conducted by the SCO as follows:</p> <ol style="list-style-type: none"> A. When a CPA is authorized to conduct LEA annual financial statement and compliance audits in CPADS, require the SCO to conduct a quality control review after the CPA's first LEA audit is completed. B. If an authorized CPA in CPADS has not conducted an LEA financial statement and compliance audit for three or more years, require the SCO to conduct a quality control review after the CPA's first LEA audit is completed. C. Require the SCO to conduct quality control reviews of CPAs conducting financial statement and compliance audits of charter schools on a cyclical basis to ensure that all of the CPA firms are periodically reviewed.

Number	Competency	Recommendation
A4	Evaluation and Compliance with K-12 Guide	<p>To ensure that the required peer review processes capture risks related to the LEA annual financial statement and compliance audits, ensure that peer review team members:</p> <ul style="list-style-type: none"> A. Have experience conducting LEA financial statement and compliance audits. B. Include an LEA audit in the engagements selected for peer review.
A5	Evaluation and Compliance with K-12 Guide	<p>Revise the Education Code to include additional circumstances in which a CPA can be removed from the CPADS directory, such as failure to meet the new recommended training requirement, significant quality control review deficiencies, and/or significant peer review deficiencies.</p>

CERTIFIED PUBLIC ACCOUNTANT FIRM SELECTION, ROTATION, AND LATE REPORT NOTIFICATIONS

Charter school authorizers, county boards of education, CDE, and the SCO have charter school oversight and monitoring responsibilities. Charter school authorizers ensure that each charter school under its authority complies with reporting requirements and monitor each charter school's fiscal condition (Education Code section 47604.32). Authorizers are required to use the unaudited and audited annual financial reports to monitor the fiscal condition of the charter school (Education Code section 47604.33(b)). In addition, the county superintendents of schools have oversight responsibilities related to the school district annual audits conducted by CPAs. Furthermore, the CDE and the SCO both have additional oversight responsibilities related to the annual financial statement and compliance audits.

Task Force members discussed the importance of mandated notifications regarding CPA firm selection, rotation, and late audits in assisting the various oversight agencies in effectively executing their oversight and monitoring roles. Currently, there is no requirement for the various oversight agencies to be notified when a charter school changes CPA firms. CPA firms may become aware of issues during the course of their audit engagements, such as potential fraud, that should be communicated to oversight agencies in a timely manner rather than waiting for audit report issuance. Notification of CPA changes allows oversight agencies in their respective roles to assess potential risks and respond accordingly by providing enhanced monitoring, oversight, or requiring corrective actions.

Education Code section 41020(f)(1) states that it is unlawful for a public accounting firm to provide audit services to a local educational agency if the lead audit partner, or coordinating audit partner, having primary responsibility for the audit, or the audit partner responsible for reviewing the audit, has performed the audit services for that local educational agency in each of the six previous fiscal years. The Education Audit Appeals Panel may waive this requirement if the panel finds that no otherwise eligible auditor is available to perform the audit.

Certified Public Accountant Rotation

CPA rotation requirements apply to all LEAs, including school districts, county offices of education, and charter schools. LEAs may change CPAs for various reasons. Not all changes indicate concerns and may include reasons such as the charter school seeking better services or compliance with mandatory rotation requirements. However, a change in CPA could be a “red flag” that oversight agencies should monitor. Circumstances that warrant oversight agency attention may include, but are not limited to, the following:

- A CPA declining a future engagement due to potential risks identified during the current or prior audit.
- An LEA seeking another CPA due to poor audit quality.
- An LEA terminating the CPA due to disagreements between the LEA and the CPA.
- The LEA terminating a CPA and selecting a new CPA to avoid the issuance of an audit report with significant findings.

Late Audit Reports

School districts and charter schools are required to submit their audited financial reports to the SCO by December 15 each year (Education Code sections 41020(h) and 47605(m)). For school districts, county superintendents may investigate the causes for a late audit report and initiate corrective actions such as granting an extension, hiring another CPA, or working with the State Controller to investigate or perform the audit (Education Code section 41020.2). The Education Code does not specifically prescribe procedures that should be taken by authorizers if a charter school does not meet the required audit deadline. However, authorizers should investigate the causes for a late audit report under Education Code section 47604.33(b), which states that the authorizer shall use any financial or other information it obtains from the charter school, including but not limited to audited financial reports, to monitor the fiscal condition of the charter school. Furthermore, both the CDE and the SCO have additional oversight responsibilities related to the annual financial statement and compliance audits.

Audits not completed by the statutory deadline may be caused by underlying problems occurring at the school district or charter school, such as poor fiscal and accounting controls, or unreliable records. County superintendents and charter school authorizers are often notified of a late audit close to or after the report deadline has passed, even though the CPA likely had knowledge of the impending delay long before the deadline. Further, the CPA and charter school may offer authorizers different reasons for the lateness of reports. Therefore, it is essential that CPAs notify county superintendents and authorizers of late audit reports, estimated submission dates, and reasons for the delay as soon as the CPA believes that the report will be late; such notification is critical for the county superintendents and authorizers to detect potential concerns timely and carry out their monitoring and oversight responsibilities. In addition, late audit notifications will assist the CDE and the SCO in effectively carrying out their oversight responsibilities related to annual financial statement and compliance audit reports.

CPAs may be reluctant to communicate directly with county offices of education, authorizers, the CDE, and the SCO because CPAs are hired by and owe a primary duty to the school districts or charter schools that hired them. Therefore, the Education Code should be amended to require the CPAs to inform these oversight agencies of CPA rotations and late reports to ensure that the CPAs are not limited by auditor-client confidentiality requirements. CPAs are provided similar communication protections, but the protections begin only after a superintendent has determined that a school district presents a going concern risk (Education Code 41020.8). The CPA that is no longer engaged in performing the audit should provide the CPA rotation notification to the oversight agencies because the outgoing CPA has a better understanding of the LEA and the reasons for the change in CPAs.

Recommendations

Task Force members analyzed the current CPA rotation requirements and discussed potential “red flags” related to CPA rotations and late reports. The Task Force recommendations are presented in the following table:

Certified Public Accountant Rotation and Late Audit Report Recommendations

Number	Topic	Recommendation
B1	CPA Rotation	Require CPAs rotating from the audit engagement to notify the authorizer, county office of education, CDE, and the SCO when a CPA change occurs and provide the reason for the change.
B2	Late Audit Reports	Require CPAs to provide late audit report notifications to the charter school, authorizer, county office of education, CDE, and the SCO, including reasons for the delay and the estimated submission date.
B3	Oversight Agency CPA Communication Protections	Revise the Education Code to ensure that CPA communications to oversight agencies about changes in CPAs and late reports are not limited by auditor-client confidentiality requirements.

AUDIT PROCESS BEST PRACTICES

Education Code section 14502.1 requires the State Controller to develop the K-12 Audit Guide in consultation with the audit guide working group. The working group includes the State Department of Education, the Department of Finance, and representatives of the California School Boards Association, the California Association of School Business Officials, the California County Superintendents Educational Service Association, the California Teachers Association, and the California Society of Certified Public Accountants. Proposed revisions are submitted to the EAAP annually and are adopted during a public meeting in accordance with required regulatory rulemaking processes. The K-12 Audit Guide is published on the EAAP's website at <https://eaap.ca.gov/>.

CPAs must perform the annual financial statement and compliance audits in accordance with the following auditing standards and requirements:

- Auditing standards generally accepted in the United States of America (GAAS), promulgated by the American Institute of Certified Public Accountants.
- GAGAS, published by the federal Government Accountability Office.
- Title 2, U.S. Code of Federal Regulations, Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (Uniform Guidance).
- K-12 Audit Guide approved by the EAAP (Education Code section 14503(a)).
- California Business and Professions Code.

Education Code section 14504 requires the State Controller, on an annual basis, to review and monitor the annual financial statement and compliance audit reports performed by independent auditors. Additionally, the State Controller shall determine whether audit reports are in conformance with reporting provisions of subdivision (a) of Section 14503 and shall notify each LEA, office of the responsible county superintendent of schools, the Superintendent of Public Instruction, the Department of Finance, and the auditor regarding each determination.

The K-12 Audit Guide incorporates by reference GAAS, GAGAS, and the Uniform Guidance (2023-24 K-12 Audit Guide, page 1). All active CPAs are required to comply with the California Business and Professions Code applicable to CPAs. The audit procedures detailed in the K-12 Audit Guide are specific to California state compliance requirements.

K-12 Audit Guide Procedures

The Task Force discussed the K-12 Audit Guide procedures related to charter school audits and concluded that the K-12 Audit Guide was generally adequate to ensure high quality audits provided that the CPA complies with required professional auditing standards and performs the procedures as detailed in the K-12 Audit Guide. However, the Task Force determined that the K-12 Audit Guide could be expanded and strengthened by including procedures for related parties, charter school authorizer inquiries, additional audit sampling guidance, student enrollment and attendance confirmations, and by including example audit reports. The additional audit procedures and guidance will enhance the auditor's ability to detect potential fraud.

Related Parties

The GAAS (Statements on Auditing Standards [SAS], section AU 334) provide guidance to auditors on related parties and related party disclosures. California charter schools may have unique administrative structures that include related party transactions that the CPA must identify, appropriately address in the audit procedures, and properly disclose in annual financial statement and compliance audit reports. One unique administrative structure is a charter school network, which is comprised of individual charter schools that operate under the same charter management organization (CMO). The CMO, the charter school leadership, and the charter school vendors may also be related parties. These related business relationships, while legal, may represent a higher risk for potential fraudulent or wasteful expenditures.

Fraud schemes associated with related party structures have been identified in which charter schools claimed and received funds for fake students. In another scheme, charter schools were billed for services not provided or billed at rates above the current market rates for similar services, or expended funds for items that are unallowable or do not benefit students. As indicated, a related party structure is not illegal; however, such a structure should be

considered an organizational complexity that increases risk for the auditor and others providing oversight of charter schools. To address this risk, the Task Force developed recommended related party audit procedures for inclusion in the K-12 Audit Guide. These procedures are intended to assist the CPAs in identifying, evaluating, and reporting on related-party transactions. The recommended procedures apply to all LEAs but may be more crucial for charter schools due to the related parties being more commonly associated with charter schools.

Charter School Authorizer Inquiry

The Task Force recommends updating the K-12 Audit Guide to require CPAs to inquire with the authorizer about fiscal and compliance areas in which the charter school excels or may not meet expectations. Compliance areas that the CPA should inquire about include operational risks, potential fraud risks, related parties, accounting irregularities, state or federal noncompliance, or other background information pertinent to the audit. Requiring this communication may provide the auditor with additional information to identify potential fraud, compliance issues, or other risks. Audit standards require the auditor to adjust audit procedures based on the risks identified.

General Audit Sampling Concepts

GAAS provides audit sampling guidance and sampling techniques to assist the auditor in obtaining adequate assurance for the evaluation of internal controls, financial transactions, and compliance. The K-12 Audit Guide states that sampling should be based on guidance provided in Table 1 of the guide and, if the auditor deviates from the sampling methodology, the auditor should indicate the rationale for using alternate procedures in the auditor's report on state compliance.

Furthermore, GAAS and GAGAS require auditors to maintain independence both in fact and appearance, and to maintain professional skepticism. The auditor should never allow an LEA to determine the sample or dictate what documentation is sufficient for conducting the audit. Allowing an LEA to determine the sample or dictate the audit documentation seriously compromises the auditor's independence, undermines reliability of the audit results, may require a scope limitation disclosure in the audit report if the auditee does not comply with documentation requests, and may represent unprofessional conduct and potentially gross

negligence of a CPA's duty under the California Business and Professions Code based on the particular circumstances.

To confirm the importance and expectation of the CPA independently selecting the samples for audit and independently determining the sufficiency appropriateness of the audit evidence, the K-12 Audit Guide should be updated to reiterate this foundational value of the audit profession.

Audit Sample Sizes

GAAS delegates the sampling design, size, and selection of items to the professional judgement of the auditor considering the auditor's risk assessment. The auditor should select the sample in such a way that the auditor can reasonably expect the sample to be representative of the relevant population and likely to provide the auditor with a reasonable basis for conclusions about the population (SAS 122). As indicated previously, the K-12 Audit Guide states that sampling should be based on guidance provided in Table 1 of the guide and, if the auditor deviates from the sampling methodology, the auditor should indicate the rationale for using alternate procedures in the auditor's report on state compliance.

The K-12 Audit Guide currently includes guidance on sample selection size for state compliance auditing, which is based on professional audit standards guidance. Additionally, professional audit standards require the auditor to incorporate engagement risk assessment considerations, which could result in increasing sample sizes to address high risk areas. While the K-12 Audit Guide is based on guidance from professional standards, the Task Force indicated that because of the unique characteristics of charter schools, the inclusion in the audit guide of separate sampling guidance for charter schools requiring increased sampling sizes would be beneficial, especially related to nonclassroom-based attendance.

Attendance Sampling

The K-12 Audit Guide provides charter school audit procedures related to attendance. Overall, the Task Force determined that the audit procedures currently included in the audit guide for charter school attendance were appropriate, provided the auditor applied audit sampling techniques in accordance with professional standards and applied the audit procedures in the K-12 Audit Guide, which includes various compliance audit procedures for charter schools with multiple academic calendar schedules referred to as "tracks."

In the A3 charter school network fraud case, A3 fraudulently enrolled student athletes attending A3's summer athletic programs into the charter school's academic program so that it could claim average daily attendance for the athletes even though no educational services were provided. Specifically, the A3 charter school network required parents of student athletes participating in the summer athletic programs to sign master agreements that enrolled the students as A3 charter school students in academic calendar track A, which includes the summer months of the athletic program. Additionally, A3 enrolled students from private schools and other student programs into the A3 network. A3 provided the athletic programs, private schools, and other student programs a portion of the average daily attendance state funding and kept the rest.

A group of charter schools with the same CMO may form a charter school network, such as the A3 charter school network discussed above. CMOs may establish procedures and processes that apply to all of the schools within the network. Additionally, CMOs may perform budgeting, accounting, reporting, and other administrative services for the charter schools within the network. However, each charter school in a CMO charter school network is a separate LEA.

CPAs should design and perform separate audit procedures for each charter school entity for which the CPA will issue a separate annual financial statement and compliance audit report. The CPA should not combine charter school entities for audit purposes even if the charter school entities are included in the same charter school network. Additionally, charter school entities should not be combined when determining sample sizes. For example, the auditor should consult the K-12 Audit Guide and determine and apply the required sample size individually for each charter school entity.

To ensure that a representative sample is selected, and to respond to the risk that attendance irregularities may occur in any academic track, students from each academic track should be included in the audit sample selection for each charter school audited.

The Task Force recommends that the K-12 audit guide be updated to reiterate to the auditor that audit samples should be representative of the population, both at the individual charter school and from each academic calendar track. These sampling methodologies should also be applied in other circumstances, such as when a charter school is consolidated with a school district (dependent charter schools). This clarification will help ensure a representative

sample selection and strengthen audit procedures that assist the auditor in identifying potentially fraudulent enrollment and attendance reporting.

Dependent Charter Schools

Dependent charter schools are established by and remain part of the school district or county office of education that granted their charter. Unlike an independent charter school that operates independently of the school district or county office of education in almost all respects, a dependent charter school functions under the auspices of the school district or county office of education that authorized it. Dependent charter schools do not typically issue separate financial statements for each charter school, rather the dependent charter school's financial information is combined with the school district or county office of education's financial statements. Because the information is combined, CPAs may not separately sample and audit the charter school financial information. The revenue and expenditures of most dependent charter schools is small in comparison to the entire school district; therefore, a CPA would typically select for testing a corresponding small number of transactions from the dependent charter school. The Task Force recommends that the K-12 Audit Guide be updated to instruct the CPAs to audit the dependent charter schools as if they are a major fund in the financial statements. This recommendation would result in increased sample sizes of the dependent charter school's transactions. The Governmental Accounting Standards Board defines major funds if the fund's activities or assets meet certain thresholds and requires major funds to be separately presented in the financial statements.

Charter School Program Sampling

For the financial statement audit, CPAs follow guidance of GAAS, GAGAS, and Uniform Guidance to identify major programs, based on risk and materiality calculations, and report on whether the financial statements of the LEA are fairly stated. The K-12 Audit Guide builds upon the financial statement audit portion of the audit and includes state compliance audit procedures for LEAs, including certain charter school-specific components. To provide confidence in the sufficiency of the audit work, the Task Force recommended that the K-12 Audit Guide reiterate the importance of adequate audit coverage and recommended that auditors select representative expenditure samples when auditing charter school programs that are included in the K-12 audit guide.

Confirmations

The K-12 Audit Guide includes procedures for nonclassroom-based and independent study enrollment and attendance. These procedures include selecting a sample of students and applying various procedures to verify student attendance claimed, including reviewing source documents such as student work samples, teacher attendance records, and independent study agreements. Even when the auditor independently selects a sample of these documents for review following professional standards, a risk exists that the auditor may not detect wrongdoing if the charter school falsifies source documents to avoid detection.

An audit technique designed to respond to potential risks of fraud includes the use of confirmations from third parties. The confirmation process requires that the auditor request information for verification purposes directly from a third party. For example, the auditor can send a confirmation document to parents or guardians of nonclassroom-based students requesting that they verify that their child attends the charter school and dates of enrollment. GAAS provides the auditor guidance on the use of confirmations in SAS 67 and provides that the auditor's decision to use confirmations should be based on risk.

To strengthen the audit procedures to detect fraudulent claiming of nonclassroom-based students, the auditor should conduct confirmation procedures to verify that students exist and are enrolled in and attending the charter school.

Nonclassroom-Based Funding Determinations

Pursuant to Education Code section 47612.5, without an approved funding determination by the SBE, nonclassroom-based charter schools are prohibited from receiving any funding for nonclassroom-based instruction. Nonclassroom-based charter schools are required to submit a determination of funding request to the CDE by February 1 via a form on the CDE's website when their previous funding determination is set to expire using data from the prior year. CDE reviews the information submitted on the determination of funding form, may request additional information from the charter school, and may review information from the charter school's audit to verify the determination of funding data submitted. CDE then presents its funding determination recommendation to the Advisory Commission on Charter Schools, which makes a recommendation to the SBE. The SBE typically votes on the funding determinations in May. The determination of funding may be approved for a two to five year

timeframe. The determination of funding approved by the SBE includes information beneficial to charter school oversight functions such as the following:

- Charter school information.
- Financial information.
- Pupil-teacher ratios.
- Funding determination calculations.
- Supplemental information.
- Governing board information.
- Mitigating circumstances.
- Other additional information.
- Charter school certification.

Because noncompliance with conditions in the funding determination may identify potential fraud or other noncompliance risks, the Task Force recommendations include requiring procedures for the auditor to verify whether the charter school is complying with the significant terms of the approved determination of funding. For example, a significant deviation from the approved pupil-teacher ratio could indicate a risk of non-existent students and may assist the auditor in identifying potential fraud. Other key financial information may also highlight financial pressures or operational risks, or findings of noncompliance that require corrective actions. Some Task Force Members expressed that the current K-12 audit procedures were already sufficient for the year under audit. The K-12 Audit Guide includes procedures such as determining whether the charter school is eligible to receive the nonclassroom-based average daily attendance instructional funding in accordance with terms of the approved funding determination. Other procedures in the K-12 Audit Guide require the auditor to verify the accuracy of certain fiscal data and pupil-teacher ratios in the funding determination as applicable to the year being audited.

Annual Financial Statement and Compliance Example Audit Reports

To assist CPAs in preparing audit reports that comply with the K-12 Audit Guide and various disclosure requirements, the Task Force suggested adding example audit reports for school districts and charter schools. The audit report examples should incorporate best practices to meet accounting and audit reporting requirements.

Recommendations

The Task Force discussed the K-12 Audit Guide's current procedures and potential additional or revised procedures. Overall, the Task Force concluded that the current K-12 Audit Guide was adequate provided that the CPA follows professional audit standards and completes all of the audit procedures as currently required. Additionally, the Task Force identified the following recommendations that would enhance and further strengthen the existing K-12 Audit Guide:

K-12 Audit Guide Recommendations

Number	K-12 Audit Guide Topic	Recommendation
C1	Related Parties	<p>Add a new related-party audit guide section. Sample procedures are attached in Appendix 1.</p> <p>GAAS has guidelines for related parties. However, this new K-12 Audit Guide section would provide guidance regarding how to apply these standards to charter school audits for identifying, evaluating, and reporting on related parties unique to charter schools.</p>
C2	Communication	<p>Include a requirement for auditors to inquire with the authorizers to understand fiscal and compliance areas where the charter school excels, may not meet expectations, potential fraud risks, irregularities, compliance concerns, and other background information pertinent to the audit.</p>

Number	K-12 Audit Guide Topic	Recommendation
C3	Audit Sampling	<p>The Task Force identified the following recommendations related to audit sampling:</p> <p><u>General Sampling</u></p> <p>A. Add clarification to the K-12 Audit Guide that the auditor should select the samples and determine additional audit evidence required to execute the audit and audit procedures in accordance with professional audit standards. LEAs, including charter schools, should not influence the auditor’s sample selection or sufficiency of audit evidence determination.</p> <p><u>Sample Size</u></p> <p>B. Increase sample sizes and include separate sampling guidance sections for school districts and charter school sample size requirements, especially related to nonclassroom-based attendance.</p> <p><u>Attendance Sample Selection Methodology</u></p> <p>C. For schools with multi-track attendance systems, require selection of samples from each track to capture all programs, not just the largest track. Separate samples should be selected for each charter school entity, even if they are in the same charter school network.</p> <p><u>Charter School Program Samples</u></p> <p>D. Reiterate the importance of adequate audit coverage and include guidance requiring auditors to select representative samples when auditing charter school programs included in the K-12 Audit Guide.</p>
C4	Consolidated Charter Schools	<p>For charter schools consolidated within a school district or county office of education (dependent charter schools), ensure that each charter school’s transactions are audited as if the charter school was the equivalent of a major fund of the school district to ensure that each charter school’s transactions are adequately sampled, evaluated, and reported on.</p>

Number	K-12 Audit Guide Topic	Recommendation
C5	Confirmations	If the charter school is classified as nonclassroom-based, include steps for conducting confirmations of student enrollment and attendance on a sample basis. The confirmations should be sent to the student’s parents or guardians, or to adult students, and should be returned directly to the auditor.
C6	Determination of Funding	If the charter school is classified as nonclassroom-based, include procedures to determine whether the charter school submitted the determination of funding request to the CDE, whether the SBE approved the funding determination, and whether the charter school is following the significant terms of the approved determination of funding.
C7	Example Audit Reports	Add example audit reports for a school district and a charter school that incorporate best practices and meet audit reporting requirements.

Financial Statement and Compliance Audit Report Disclosures

LEA and charter school annual financial statements must be presented in accordance with applicable Generally Accepted Accounting Principles. School districts and charter schools organized as governmental entities are generally required to follow Governmental Accounting Standards Board requirements. Most charter schools are organized as non-profit organizations and are required to follow the Financial Accounting Standards Board requirements. Also, the State may require additional information to be included in the financial statements. Auditors must audit the financial statements and the additional information according to professional audit standards and the K-12 Audit Guide.

The Task Force discussed the importance of the information contained in the annual financial statement and compliance audit reports used by charter school authorizers, county offices of

education, the CDE, and the SCO to conduct their oversight responsibilities. The annual financial statement and compliance audit reports also provide information to the public regarding charter school operations and the expenditure of taxpayer funds. The Task Force reviewed the annual financial statement and compliance audit report disclosures to determine if additional information should be included in the report to foster a culture of accountability and transparency and provide information to support charter school oversight responsibilities.

Consolidated School District Disclosures

Charter schools that receive funding directly from the school district or county office of education and are operationally integrated into their authorizing school district or county office of education are referred to as “dependent” charter schools, which typically do not issue separate financial statements. Instead, the dependent charter school’s financial information is combined with the authorizing school district or county office of education’s financial statements. The annual financial statement and compliance audit reports are not currently required to present the financial information of the charter schools separately. As a result, the school district or county office of education may have one or more dependent charter schools consolidated within its financial statements.

Without the charter school financial information displayed separately from the school district or county office of education, oversight agencies are unable to effectively assess the financial operations of the charter school(s) or identify concerns that could mitigate or detect fraud or other operational concerns. Separately disclosing each dependent charter school’s financial information in the supplementary information section would provide financial information to assist the various oversight agencies in carrying out their responsibilities.

Related Parties and Associated Disclosures

The Task Force discussed various information that would be beneficial for strengthening related party disclosures. Accounting principles and professional auditing standards provide guidance on related party disclosures; however, the guidance is not specific to charter school issues and may leave the determination of what should be disclosed to the charter school and the professional judgment of the auditor. Given the recent charter school fraud schemes wherein related parties played a significant role in collusion and fraud, the Task Force believes that additional discussion is needed to further develop clear related party disclosure criteria for charter schools.

To help identify related parties and identify potential risks, the Task Force identified the following items for disclosure in the financial statement and compliance audit reports:

- CMO board members.
- CMO management.
- charter school board members.
- charter school management.
- loans between schools in CMO networks.
- shared employees.
- top five highest-paid charter school employees and their total compensation.
- top 25 highest-paid charter school vendors.

During Task Force discussions, some Task Force members expressed that they did not believe the top 25 highest-paid charter school vendors should be disclosed in the financial statement and compliance audit reports while others expressed a desire to include the top 50 highest-paid charter school vendors in the audit reports.

Funding Determination Disclosures

Because the approved determination of funding is not provided to authorizers, disclosing the funding determination data in the annual audit report would assist authorizers in conducting their oversight duties. Additionally, this would provide the authorizer and others with crucial information, such as approved pupil-teacher ratios. However, the funding determinations are valid for two to five years, and the financial information is based on information for the year prior to the funding determination request. As a result, the funding determination data disclosed in the financial statement and compliance audit may not reflect the current operating environment and may conflict with other more current disclosures in the audit report.

Enrollment and Attendance Disclosures

The Task Force discussed enrollment and attendance information that would assist in the monitoring and oversight of LEAs, including charter schools. In the A3 fraud case, the A3 network had exponential increases in enrollment and attendance; inclusion of this information in the annual financial statement and compliance audit may have allowed those with oversight responsibilities to more quickly identify and take appropriate action to investigate the potential fraud risk. Specifically, the Task Force members recommend including separate schedules for enrollment and attendance that present the number of students at the beginning of the audit period, added, transferred, and departed by track and by month.

Recommendations

The Task Force recommends the following audit report disclosures to assist in meeting oversight responsibilities of LEAs, including school districts, county offices of education, and charter schools. The additional disclosures will provide additional information for oversight agencies to identify fraud risks so that potential fraud can be identified timely and curtailed.

Audit Report Disclosure Recommendations

Number	Audit Report Disclosure Topic	Recommendation
D1	Consolidated Charter School Disclosures	For charter schools consolidated within a school district or a county office of education, require that financial data for each charter school be presented separately in the supplemental section of the audit report.
D2	Related Party Disclosures Workgroup	Convene a working group to further develop clear criteria for related party disclosure expectations for all LEAs.

Number	Audit Report Disclosure Topic	Recommendation
D3	Related Party Disclosures	<p>Require that the annual financial statement and compliance audit reports include the following disclosures:</p> <ul style="list-style-type: none"> A. CMO management and board members, charter school management and board members, others related to the schools that the CMO serves, information about loans between related schools, and shared employees. B. The top five highest-paid school employees. The disclosure should include the individuals' names, position/titles, and total compensation, including a breakdown of amounts paid by compensation category (i.e., salary, fringe benefits, other compensation, etc.) C. The top 25 highest-paid vendors that provide goods and services and the total amount paid, including the charter school authorizer and affiliates.
D4	Determination of Funding	Disclose determination of funding data in audit reports every year.
D5	Enrollment and Attendance	Require separate schedules for enrollment and attendance that present students beginning, added, transferred, and departed by track and by month.

POTENTIAL IMPLEMENTATION OBSTACLES AND SOLUTIONS

The public expects the fiscal accountability and transparency of all LEAs, including school districts, county offices of education, and charter schools. The Task Force members were intensely committed to timely identification and mitigation of potential fraud. This report reflects the general consensus of the Task Force members for recommendations to further enhance charter school audit functions to timely identify and curtail fraud. Furthermore, most of the recommendations in this report should also be applied to all LEAs.

Implementation of the majority of the recommendations in this report will require legislative action. While the various LEA sector organizations are committed to identifying and mitigating fraud in the LEAs, including school districts, county offices of education, and charter schools, particular agency and other stakeholder perspectives have historically differed regarding how to effectively mitigate fraud without putting undue burden and costs on California charter schools, other LEAs, CPAs, and respective oversight agencies. Most of the recommendations, if implemented, would require additional funding and resources by the implementing entity. At the state level, budgetary approval through the State's legislative process would be necessary to obtain the resources and additional personnel necessary to successfully implement recommendations. At the local level, many of the recommendations will result in additional costs to the LEA, charter school, authorizer, and county offices of education. The State may reimburse these additional local level costs through its mandated cost provisions; however, this process can take years before costs are recognized as mandated costs. Furthermore, the mandated cost reimbursement process is ultimately left to the State's legislative budget process.

Recommendations resulting in changes to the K-12 Audit Guide must be presented to the audit guide workgroup prior to submission to EAAP, and final approval by the EAAP must be obtained through the rulemaking process. The K-12 Audit Guide working group must generally support changes to the K-12 Audit Guide and audit report disclosure enhancements prior to submitting revisions to the EAAP. However, if a new legislative requirement results in a revision to the K-12 Audit Guide, the audit guide working group must add the revision and are tasked with developing the appropriate audit procedures or disclosure requirements to implement the new legislative requirements. Expansion of the K-12 Audit Guide procedures

and disclosure requirements will result in increased audit costs charged to the LEAs by CPA firms implementing the additional procedures.

Overcoming these obstacles may require communication and collaboration with the various stakeholders and legislative consultants in the LEA sector. Some potential opportunities to gain support may be stakeholder information sessions or other informational campaigns to build on the importance of charter school and LEA reform. Gaining support from the various stakeholders would strengthen the commitment to a culture of transparency and accountability in the LEA sector and promote trust and confidence in the oversight of California LEAs, including charter schools.

OTHER RECENT STUDIES

In addition to this Task Force, other organizations have recently published reports that promote charter school accountability and identify additional ways to mitigate fraud risks and provide support when fraud risks are identified. Recently, two such reports were issued as follows:

- Review of the Funding Determination Process for Nonclassroom-Based Charter Schools, published by the Legislative Analyst Office and the FCMAT at: <https://lao.ca.gov/Publications/Report/4870>
- Protecting California Public Schools Against Fraud: The Charter School Sector and Beyond, published by the California Charter Authorizing Professionals at: <https://calauthorizers.org/protecting-california-public-schools-against-fraud/>

Both of these reports complement the work of this Task Force and include additional recommendations for consideration to further support LEA accountability and transparency, and to mitigate and address the risks of fraud in charter schools.

CONCLUSION

To adequately combat fraud in charter schools, it is important that all oversight agencies, in addition to the charter school audit function, implement strong internal and monitoring controls to timely identify and mitigate potential fraud. These controls should begin with the charter school petition approval process, charter school accountability systems, authorizer monitoring of charter schools, and the respective oversight functions of the charter school governing board, county offices of education, CDE, and SCO. FCMAT also provides support and oversight services, including fraud audits. In addition, various other organizations support LEAs by hosting conferences, providing tools and templates, workgroup opportunities, and various other resources.

The Task Force extensively discussed the current state of California charter schools and developed various recommendations based on the combined multi-disciplinary expertise and experience of the Task Force members. Overall, Task Force members achieved full consensus or majority consensus for the recommendations in this report, with the exception of the recommendation related to audit procedures for nonclassroom-based funding determination, which had a minority consensus. The recommendations in this report are intended to foster a culture of transparency and accountability through further enhancing auditor expertise, authorization requirements, evaluation and compliance with the K-12 Audit Guide, audit guide procedures, and audit report disclosures for charter schools. Further, the Task Force determined that most of the recommendations should be applied to all LEAs, including school districts, county offices of education, and charter schools, and provide an opportunity to strengthen audit functions across the entire LEA system.

APPENDIX 1

Recommended New Related Party Audit Procedures for Charter Schools

Definitions

A material related party may consist of, but is not limited to, an organization, entity, corporation, partnership, disregarded entity, limited liability company/partnership, individual, vendor, contractor, service provider, charter management organization, nonprofit organization (includes the charter school's nonprofit public benefit corporation), economic management organization, back-office service provider, administrative entity, or similar types of organizations or entities, but excluding governmental agencies. A material related party may have a material or controlling financial/economic interest or can exercise material/significant control, or a controlling interest over or upon the charter school or the charter schools' nonprofit public benefit corporation.

- Material or controlling financial/economic interest may be evidenced by:
 - The material related party receives a material dollar amount of payments or revenue from the charter school.
 - The charter school pays or disburses a material dollar amount of payments to the material related party.
 - The material related party has a right to or responsibility for the charter school's operating results.
- Material or significant control or a controlling interest may be evidenced by the material related party exercising influence over the charter school's decisions. Exercising influence over the charter school's decisions may be when the material related party:
 - Has a controlling interest, common management or board, majority voting interest over the charter school or its governing board.
 - Has placed management of the material related party within the charter school.
 - Is a sole corporate member or sole statutory member over the charter school.

Audit Procedures

1. Determine if any material related party relationship exists within the charter school or its nonprofit public benefit corporation.
 - a. Determine if the charter school and the charter school's nonprofit public benefit corporation have a governing board policy and/or administrative regulation, other board approved operations manual, or bylaws or related documents describing related parties and how they are identified and treated for disclosure in the financial statements.
 - b. Evaluate the charter school and the charter school's nonprofit public benefit corporation's policies and procedures for identifying, properly accounting for, and disclosure of related parties.
 - c. Request from management the names of all related parties and whether there were any transactions during the year under audit.
 - d. Review the charter petition, renewal charter petition, articles of incorporation, bylaws, memorandum of understanding, and contracts of the charter school and charter school's nonprofit public benefit corporation for any potential material related parties.
 - e. Inquire of predecessor, principle, or other auditors of related entities concerning their knowledge and extent of any existing related parties.
2. Review the charter school and the charter school's nonprofit public benefit corporation's customer list, vendor list, and other lists for names for potential material related parties.
 - a. Cross review these lists of names with the charter school and charter school's nonprofit public benefit corporation Statement of Economic Interests (Fair Political Practices Commission Form 700) disclosures.
 - b. Review the extent and nature of business transacted with major customers, vendors, borrowers, lenders, and any other significant transactions for indications of potential related parties.
 - c. Consider whether transactions are occurring, but are not recognized in the accounting records, such as receiving or providing accounting, management, or other services at no charge or a charter school benefactor/donor is absorbing expenses of the charter school or charter school's nonprofit public benefit corporation.

- d. Review the charter school's nonprofit public benefit corporation income tax filing (Internal Revenue Service Form 990) for indications of potential related parties.
3. Review material asset, liability, equity, revenue, and expenditure transactions during the audit period for potential material related parties.
 - a. Review loan receivable and payable contracts; memorandum of understanding/contracts; property, plant, or equipment purchases or transfers; cash and investments transfers; and other financial agreements or arrangements for indications of guarantees or assignments of collateral. Determine the nature of any guarantees, collateral arrangements, and the relationships, if any, of the guarantors to the charter school or its nonprofit public benefit corporation.
4. Review the governing board meeting minutes regarding material transactions to identify potential material related parties.
5. Review accounting records for large, unusual, or nonrecurring transactions or balances, focusing on transactions recognized at or near the end of the reporting period.
6. Determine if a material related party exists that should be disclosed in the notes of the financial statements. When a material related party is identified, the auditor should decide the level or degree of assurance required to determine the extent to which the available information provides the assurance necessary to decide about the existence and disclosure of a material related party relationship. To assist in making such a determination, conduct the following procedures:
 - a. Obtain an understanding of the business purpose of the transaction by examining all documents necessary to validate an understanding of the business purpose of the transaction, such as invoices, signed agreements, memorandum of understanding/contracts, terms of contracts/agreements, guarantees, and other significant information with the parties of the transaction.
 - b. Confirm and obtain satisfaction concerning the transferability, nature, and value of any collateral arrangements.
 - c. Confirm that the transactions were properly approved by management and/or the governing board.

- d. Background check, research, inquire with the charter school and the charter school's nonprofit public benefit cooperation management and governing board as to the disposition of any prospective material related parties.
- e. If the charter school or the charter school's nonprofit public benefit corporation and material related party have due to/from or intercompany or intercompany account balances, examine such balance for agreement.
 - (1) If the charter school or the charter school's nonprofit public benefit corporation and material related party have different fiscal year end dates, arrange for examination of the balances as of concurrent dates.
- f. Evaluate all available records and information pertaining to a material related party transactions(s) for reasonableness and determine the amounts and information to be presented for disclosure in the financial statements.
- g. If a material related party relationship is determined that it must be consolidated into the charter school's audit report, then, ensure that the financial statements of the material related party are reviewed through a separate independent audit.
- h. If such a material related party relationship is determined and the consolidation of financial reporting is required, then prepare a side-by-side comparison of board members and executive management to be presented in the notes to the financial statement of the charter school's audit report.

Additional Information

- SAS section AU 9334—subsection 6.17, The Nature and Extent of Auditing Procedures for Examining Related Party Transactions: “The auditor’s procedures should be sufficient to provide reasonable assurance that related party transactions are adequately disclosed and that identified related party transactions do not contain misstatements that, when aggregated with misstatements in other balances or classes of transactions, could be material to the financial statements taken as a whole. As in examining any other material account balance or class of transactions, the auditor needs to consider audit risk⁴ and design and apply appropriate substantive tests to evaluate management’s assertions.”
- Audit risk and its components are described in SAS section AU 312, Audit Risk and Materiality in Conducting an Audit.

- Consolidation is a component of related party disclosure rules (Financial Accounting Standards Board [FASB] Accounting Standards Codification [ASC] 958-20 and 850-10), commonly controlled entities (FASB ASC 810-10), controlling financial interests, (FASB ASC 958-810) and other generally accepted accounting procedures constraints on when consolidation is required, permitted, and not permitted.

Research Sources

SAS section AU 334 – Related Parties (FASB ASC 850-10-50) AU Section 9334 – Related Parties: Auditing Interpretations of Section 334.