

December 11, 2017

Hawaii Board of Accountancy
Hawaii Society of Certified Public Accountants

Regarding – Overreaching use of audits and potential effects.

Executive Summary: As noted in the attached Notice of Prospect of Revocation, the State of Hawaii Charter School commission is moving towards revoking the charter of a public charter school and immediately withholding State payments to the school, apparently based solely on audit findings in a GAS audit report. Thus, it is hereby noted that CPA audit findings are being used as sufficient legal evidence with no apparent follow-up or due diligence by the State to levy punitive damages.

The revocation of a charter school is a legal matter whereas an audit and the resulting findings are accounting matters. In the audit report, management provided credible corrective actions plans and the audit opinion itself was unmodified. CPAs are not legal experts and can not provide legal opinions. Audit findings are based on perceived internal control issues and lack of compliance based on CPA professional judgement and limited testing. Audit findings from a GAS audit relate to internal control issues and compliance issues which can range from severe to minor; but, audit reports are not designed to differentiate.

Audit testing and auditor judgment varies greatly among audit Firms. Firms, like ours, would be doing a disservice to our clients if we use our many years of expertise and diligent audit skills to identify internal control and compliance issues beyond the bare minimums required by auditing standards. We believe the client base would be much better off to know deeper issues and provide corrective action plans to improve than to not know. But punitive damages from Government agencies relying on the audit report may prevent that growth from occurring. Thus, an ethical issue of excellent auditing versus minimal auditing is noted.

Furthermore, the vast majority of Board of Directors are comprised of volunteer leaders and the audit is a valuable service to provide assurance and improvement via the audit reports, management letters and findings. In our experience over thousands of audits and 30 years, Federal, State and County governmental agencies viewed the corrective action plans favorably and appreciated a thorough audit. The situation discussed in this letter shows an opposing governmental action, whereby the audit findings are the basis of Governmental consequences which are levied immediately with no apparent follow-up or evaluation.

As our profession's oversight representatives, we request your assistance to answer the following pertinent questions:

1. Is it the intent of audit reports, including findings, to provide government agencies with sole, adequate support to make a legal conclusion and exercise government action upon the auditee?
2. Are Government actions based on GAS audit findings without due diligence by the State placing our audits in a legal determination position thus opening up CPAs to lawsuits because we are making final, legal determinations with our internal control conclusions and financial findings, even when the audit report itself is unmodified?
3. Is it possible many audits are being issued with clean opinions and no findings that would not be issued as such except for the threat of government consequences rather than client improvement as the perceived outcome?

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Background: We performed an audit of the Ka'u Learning Academy PCS and issued our final report. Please see attached audit report. The audit reported:

- An unmodified opinion on the Financial Statements.
- GAS Audit Report:
 - Two Material Weaknesses 2017-001 and 2017-002
 - One Instance of Noncompliance noted as 2017-003.
- Management's Response and Corrective Action Plan.

On November 28, 2017, the State of Hawaii Public Charter School Commission met with the Ka'u Learning Academy PCS (School) to discuss the School's audit.

On November 29, 2017, the State Public Charter School Commission sent a Notice of Prospect of Revocation to the School. See State letter attached. Of particular concern in the letter is the following excerpt:

The State Public Charter School Commission's (Commission's) determination to issue this Notice of Prospect of Revocation was a result of a review of an independent auditor's audit report that cited KLA for several material weaknesses and incidents of non-compliance, specifically:

- **Finding 2017-001: Lack of Internal Controls and Additional Oversight - continuation of 2016-001**
- **Finding 2017-002: Accounting does not follow Generally Accepted Accounting Principles (GAAP)**
- **Finding 2017-003: Non-compliance with Department of Labor Laws and Regulations**

Furthermore, the State of Hawaii is taking the following immediate punitive actions:

1. To notify all the student parents of the Commission's decision and the process of charter revocation that will occur. Dated November 29th, in the attached letter from the State of Hawaii Public Charter School Commission.
2. Withhold the state's second payment to the school due December 1, 2017. This is 2 days after the date of the State of Hawaii letter and 3 days after their meeting and notice.

Additionally noted in the letter are the following comments related to the audit:

"It was the Commission's determination that the results of KLA's audit report raise concerns pertaining to all three provisions stated above. (*below*) During the discussion and deliberation, the Commission raised concerns regarding the lack of understanding of governance support, structure, and involvement of the school's governing board.

The 3 provisions noted in the report are legal and serious:

- (1) Committed a material and substantial violations of the terms, conditions, standards, and/or procedures required under its Charter Contract;
- (2) Failed to meet or make sufficient progress toward performance expectations set forth in the contract; and
- (3) Failed to make generally accepted standards of fiscal management.

As a result of the meeting and following Notice, our audit client, the School, was concerned that the audit put the school in harms way and that the audit process, including the management response and corrective action plan, was not only useless, but also self-defeating. They would have been better off fighting the audit results rather than taking the information to improve.

GAO and AICPA pronouncements: The following excerpts from professional standards are hereby noted. We also will make comments following each one relevant to this discussion:

AICPA AAG GAS Chapter 4, Paragraph 4.07. *Auditors should communicate in the report on internal control over financial reporting and compliance, based upon the work performed, (a) significant deficiencies and material weaknesses in internal control; (b) instances of fraud and noncompliance with provisions of laws or regulations that have a material effect on the financial statements and any other instances that warrant the attention of those charged with governance; (c) noncompliance with provisions of contracts or grant agreements that has a material effect on the financial statements; and (d) abuse that has a material effect, either qualitatively or quantitatively. Auditors report on internal control and compliance regardless of whether or not they identify internal control deficiencies or instances of noncompliance.*

Comment: Given the situation in this letter, we believe there are legal and ethical issues in that “based upon work performed” does not imply a legal determination or objective as part of the audit. Also, the quality and amount of work performed will vary greatly among audit Firms. Thus, we see the legal problem of elevating audit findings to be the basis of government sanctions. And we see the ethical issue of working harder and digging deeper to help clients improve as opposed to minimal work to find the least amount of issues possible.

Government Auditing Standards (Yellow Book) Chapter 3; paragraphs 3.60 – 3.68 all relate to Professional Judgement. The following is only the first 2 paragraphs:

3.60 Auditors must use professional judgment in planning and performing audits and in reporting the results. 3.61 Professional judgement includes exercising reasonable care and professional skepticism. Reasonable care includes acting diligently in accordance with applicable professional standards and ethical principles. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of evidence. Professional skepticism includes a mindset in which auditors assume neither that management is dishonest nor of unquestioned honesty.

Comment: Our professional judgment is not a legal one. We are not trained lawyers with respect to government law and in this case the intricacies of the Hawaii charter school law referenced in the Notice of Prospect of Revocation. Also, there is a wide range of possibilities between “management is dishonest and unquestioned honesty. Therefore, non-legal professionals with a wide range of professional skepticism will vary greatly in their interpretations, applications and ultimately in their reporting of findings with respect to compliance with certain provisions of laws, regulations, contracts and grant agreements. Thus, an ethical issue is heightened where a more thorough, skilled auditor could damage a client as opposed to a less motivated auditor that does not find compliance issues because of the threat of government imposed damages to their client. This issue is further exacerbated since the audit itself states that it is not designed to provide an opinion on compliance with laws, contracts, etc. and the reporting of such is not even an objective of the audit.

Questions to be answered: We see this as an important issue that should be resolved at the governing levels of our profession. I personally do not believe this is an isolated incident. But, as you can see from the attached front-page story, it is front and center and I think a good time to set a precedent for our profession and to the State of Hawaii and Counties of Hawaii. Therefore, as our profession’s oversight representatives, we request your assistance to answer the following pertinent questions:

1. Is it the intent of audit reports, including findings, to provide government agencies with sole, adequate support to make a legal conclusion and exercise government action upon the auditee?
2. Are Government actions based on GAS audit findings without due diligence by the State placing our audits in a legal determination position thus opening up CPAs to lawsuits because we are making final, legal determinations with our internal control conclusions and financial findings, even when the audit report itself is unmodified?
3. Is it possible many audits are being issued with clean opinions and no findings that would not be issued as such except for the threat of government consequences rather than client improvement as the perceived outcome?

We are concerned that precedence is being set regarding the governmental use of audit reports which will harm the profession in the future as follows:

- Creates legal exposure for CPA audits that extend beyond current guidelines.
- Creates an adversarial relationship between CPA auditors and their clients.
- Creates an environment where minimal auditing and minimal reporting is rewarded instead of discouraged.

As licensed CPAs under your oversight, we look forward to your answers to these questions. We believe the situation noted in this letter is not an isolated incident. Ultimately, we need to direct our Firm to represent the public at large and perform our audits according to laws and pronouncements. Therefore, we are requesting credible answers to the above questions which will constructively help our Firm and our profession.

I personally believe doing nothing with these issues will create an unrecoverable situation for our audit profession. We can't perform government investigations that are legal in nature and provide credible services to our clients. It's like hiring the IRS to do your tax returns! I believe we are being pushed into a legal corner and I think no action could set future precedence.

Thank you for your consideration,

John D. Carbonara CPA

CC Ka'u Learning Academy PCS