LEGAL SERVICES CORPORATION

OFFICE OF INSPECTOR GENERAL

FINAL REPORT ON SELECTED INTERNAL CONTROLS

RHODE ISLAND LEGAL SERVICES, INC.

RNO 140000

Report No. AU 16-05

March 2016

www.oig.lsc.gov

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INTRODUCTION

The Legal Services Corporation (LSC) Office of Inspector General (OIG) assessed the adequacy of selected internal controls in place at Rhode Island Legal Services (RILS or grantee) related to specific grantee operations and oversight. Audit work was conducted at the grantee's administrative office in Providence, RI and at LSC headquarters in Washington, DC.

In accordance with the Legal Services Corporation Accounting Guide for LSC Recipients (2010 Edition) (Accounting Guide), Chapter 3, an LSC grantee "…is required to establish and maintain adequate accounting records and internal control procedures." The Accounting Guide defines internal control as follows:

> [T]he process put in place, managed and maintained by the recipient's board of directors and management, which is designed to provide reasonable assurance of achieving the following objectives:
> 1. safeguarding of assets against unauthorized use or disposition;
> 2. reliability of financial information and reporting; and
> 3. compliance with regulations and laws that have a direct and material effect on the program.

Chapter 3 of the Accounting Guide further provides that each grantee "must rely… upon its own system of internal accounting controls and procedures to address these concerns" such as preventing defalcations and meeting the complete financial information needs of its management.

BACKGROUND

Rhode Island Legal Services provides legal assistance and representation to low-income individuals and eligible client groups for the purpose of improving their economic condition and overall wellbeing by protecting and enforcing legal rights, stabilizing the family unit and communities where clients live, promoting self-reliance, ending domestic violence, preventing homelessness, affording dignity to all people, and reaching out to groups with added burdens on their ability to access the civil justice system. RILS serves Bristol, Kent, Newport, Providence and Washington counties with offices at its Providence and Newport locations.

According to the audited financial statements for the grantee's year ended December 31, 2014, approximately 29 percent of the grantee's total support funding was provided by LSC. RILS received $930,837 from LSC; $100,000 from the Internal Revenue Service, $771,237 from the Rhode Island Attorney General, $224,976 from the Rhode Island Bar Foundation, $809,051 from the Rhode Island Judiciary and $317,435 from other grants and contracts.

OBJECTIVE

The overall objective was to assess the adequacy of selected internal controls in place at the grantee as the controls related to specific operations and oversight, including program expenditures and fiscal accountability. Specifically, the audit evaluated select financial and administrative areas and tested the related controls to ensure that costs were adequately supported and allowed under the LSC Act and LSC regulations.

AUDIT FINDINGS

To accomplish the audit objective, the OIG reviewed and tested selected internal controls related to derivative income, contracting, fixed assets, credit cards, employee benefits, general ledger and financial controls, internal reporting and budgeting and a limited review of payroll.

Based on our testing of grantee's cash disbursements, we found that for the most part, grantee's internal controls in place at the time of our audit visit were adequately designed and properly working. We did not find any significant instances to report.

While many of RILS' controls were adequately designed and properly implemented as the controls related to specific grantee operations and oversight, some controls need strengthening while others need to be formalized in writing.

ATTORNEYS' FEES AND DERIVATIVE INCOME (INTEREST INCOME)

The LSC OIG examined RILS's derivative income and attorneys' fees during the audit period and determined that the grantee did not have written policies in either of these areas. The OIG found that the practices in place related to both derivative income and attorneys' fees do not fully adhere to LSC guidelines.

Attorneys' Fees

The attorneys' fees allocation methodology in practice is not in conformity with LSC regulations. The grantee allocates all attorneys' fees awarded for a case based on the primary funder of the case. All of the fees are attributed to the funding source with the most hours charged, instead of being allocated in proportion to the funding sources used to charge attorney's time expended for a particular case.

45 CFR §1609.4 provides that:

> (a) Attorneys' fees received by a recipient for representation supported in whole or in part with funds provided by the Corporation shall be allocated to the fund in which the recipient's LSC grant is recorded in the same proportion that the amount of Corporation funds expended bears to the total amount expended by the recipient to support the representation.

During the period under review, the grantee received a total of $30,508.15 in court awarded attorneys' fees. Our review of eight attorneys' fees transactions from this period revealed that one transaction in the amount of $2,291.66 was totally allocated to a non-LSC funding source. This occurred because the non-LSC funding source was charged the majority of the hours for that case. Based on LSC regulations, the OIG determined that 21 percent or $481, of attorneys' fees from this transaction should have been allocated to LSC.

Further analysis of grantee's attorneys' fees revealed that approximately 90 percent of attorneys' fees received in the year 2015 to date were allocated to LSC.

RILS' Finance Officer explained that she was unaware of LSC's requirement to allocate attorneys' fees to funding sources based on how attorneys charged their time to those funding sources.

Properly recording attorneys' fees in accordance with LSC regulations allows LSC to be allocated its apportioned share, which in turn can be used to provide legal services in accordance with LSC requirements. The OIG is questioning a total of $481 in attorneys' fees and will refer the questioned amount to LSC management for review and action.

<u>Interest Income</u>

RILS' interest income allocation methodology in practice is not in conformity with LSC guidelines. The grantee allocated all of the interest income received over the audit period to an unrestricted account. However, the OIG determined that the Finance Officer prepared adjusting entries for the year 2015 to date to allocate LSC its appropriate share of interest income. These adjusting entries will result in $151.18 allocated to LSC for the year 2015 to date. The Finance Officer did not anticipate adjusting 2014 interest income, a total of $316, due to the year-end having been closed and the subsequent issuance of audited financial statements.

RILS's Finance Officer stated that she was unaware of LSC's requirement to allocate interest income on proportional basis as stated in the LSC regulations.

45 CFR§1630.12 (a) states:

> Derivative income resulting from an activity supported in whole or in part with funds provided by the corporation shall be allocated to the fund in which the recipient's LSC grant is recorded in the same proportion that the amount of corporation funds expended bears to the total amount expended by the recipient to support the activity.

Failure to have an allocation methodology for derivative income such as interest income may result in an unfair allocation of the total amount of interest income credited back to the appropriate funding source.

Written Policies

In our review of RILS' derivative income policies and procedures, the OIG noted that the grantee's Accounting Manual does not have written policies or procedures on derivative income and attorneys' fees.

The *Fundamental Criteria of an Accounting and Financial Reporting System* (*Fundamental Criteria*) contained in the LSC Accounting Guide provides that each grantee must develop a written accounting manual that describes the specific procedures to be followed by the recipient in complying with the *Fundamental Criteria.*

The Executive Director stated that policies for derivative income were not included in the grantee's Accounting Manual due to a management oversight. Failure to have written policies and procedures may result in incorrect allocation of derivative income and related attorneys' fees.

Recommendations: The Executive Director should ensure:

Recommendation 1: attorneys' fees are allocated in accordance with the requirements specified in 45 CFR § 1609.4;

Recommendation 2: interest income is allocated in accordance with the requirements specified in 45 CFR § 1630.12;

Recommendation 3: the grantee develops and implements a written derivative income policy that covers all types of derivative income received by the grantee, including provisions for attorneys' fees contained in 45 CFR §1609.4.

CONTRACTS

Contracting Policy

The OIG examined RILS' business arrangements during the audit period and determined that the grantee's contracting policies did not fully adhere to LSC guidelines. In addition, the grantee's Accounting Manual did not contain all of the elements required by the *Fundamental Criteria* contained in the LSC Accounting Guide, including contracting procedures for different types of contracts, competition, documentation and approval requirements.

The Executive Director stated they were not aware that the processes of contract action were required to be documented and that the documentation supporting justification for vendor selection and sole source contracts were required to be maintained. Also, with respect to competition, the grantee has an official policy of only requiring competition for consulting contracts $25,000 and above. However, in our conversations with the Executive Director, he stated that he tries to seek competition for all contracts by obtaining bids and quotes from various vendors in order to get the best service and price available.

Contracting Test Work

The OIG judgmentally selected seven vendors for testing and found that:

- None of the seven contracts had documented the process for the contract actions;
- None of the contracts met the grantee's set dollar threshold limit of $25,000 to require solicitation of bids;
- Two contracts did not have sole source justifications for contracts awarded without competition and the other five contracts tested did not have documented justification for vendor selection;
- One contract was not documented in writing; and
- None of the contracts and related documentation were centrally filed.

The Executive Director explained that the grantee did not have a written agreement for one of the contracts, a temporary staffing agency, because of an urgent requirement during the time. There were no emails or other communications between RILS and the vendor outlining the price and scope of services to be provided by the vendor. While the OIG was on site, the Executive Director contacted the vendor to obtain a copy of the contract. He was informed that the vendor does not provide written finalized contracts, except what was agreed upon in general terms ahead of temporary staff placement.

The *Fundamental Criteria* stipulates that the process for each contract action should be documented and maintained in a central file. Any deviation from the approved contracting process should be fully documented, approved and maintained in the contract file. In addition, the statement of work should be sufficiently detailed so that contract deliverables can be identified and monitored to ensure that deliverables are completed.

By not documenting the justification for selection of vendors and the reason the contracts were not subject to competition, it is not clear whether the grantee received the best price and service available for the money spent. Without a centralized filing system, the grantee cannot ensure that the approved contract followed all established procedures, resulting in a possible loss of contracting documentation. Without a formal contract, the statement of work and other contract terms cannot be adequately communicated and monitored, which may obstruct management's ability to prevent or detect the risk of fraud, waste and abuse.

Recommendations: The Executive Director should:

Recommendation 4: enhance and revise existing written policies to ensure they address the elements required by the *Fundamental Criteria;*

Recommendation 5: ensure all products and services obtained or performed within specific, agreed-upon terms are supported by a valid formal document;

Recommendation 6: ensure that the contracting practices adhere to LSC requirements including:

- Process used for each contract action is fully documented;
- There is adequate support for competition and sole-sourcing of contracts; and,
- The grantee maintains a centralized filing system for all contracts, where a file is established for a specific contract containing all pertinent documents related to the solicitation of bids, including receipt and evaluation of bids, vendor selection or sole source justification, and the award of the contract.

FIXED ASSETS

Biannual Inventory

The OIG reviewed the grantee's internal controls over capitalized and non-capitalized fixed assets, including electronic items, and determined that the physical inventory count was not conducted every two years. The most recent inventory count was conducted in 2014, and before that, in 2009.

The Executive Director explained that the grantee has not been conducting a physical inventory count once every two years due to a management oversight and a poor asset management system. He also stated that the grantee acquired cloud based inventory management software in March 2015, which will improve the grantee's asset management practices.

Section 2-2.4 of the LSC Accounting Guide states that:

> For property control purposes, a physical inventory should be taken and the results reconciled with the property records at least once every two (2) years. Any differences between quantities determined by physical inspection and those shown in the accounting records shall be investigated to determine the causes of the difference, and the accounting records should be reconciled to the results of the physical inventory with an appropriate note included in the financial statements, if determined to be material by the recipient's auditor.

Proper accounting for fixed and physical assets and adequate maintenance of property records will safeguard assets, provide accountability for assets purchased and support reconciliations such that asset balances are accurate.

Newport Office Inventory Not Counted

The grantee did not perform an inventory count at its Newport Branch Office as part of their 2014 inventory. The grantee explained that the Newport office has space for four people, but currently only has two individuals. During review of the grantee's fixed assets listing, the OIG noted that the inventory records did not reflect any assets located at the Newport office. Upon further inquiry, the grantee stated that the Newport office inventory was not counted in 2014.

In discussion with the Executive Director, he explained that he was not aware that the Newport office inventory was not counted until the OIG informed him during the audit process. He added that he was on leave at the time of the inventory count in 2014. Upon his return, he was informed by the staff that the inventory count had been completed. He stated that he did not verify whether the Newport office fixed assets items were being inventoried. The Executive Director asserted that the grantee will take immediate action to count the fixed asset items located at the Newport office and add them to its new property system.

Missing Elements on Property Listing

As part of our test work, the OIG reviewed the grantee's internal controls over fixed assets. We found that the grantee did have controls in place to properly track its property. However, the grantee's property listing contained deficiencies.

RILS' fixed assets listing did not include all of the components required by the *Fundamental Criteria*. The missing required components were: (1) depreciation method, (2) salvage value, if any (3) method of valuation (if donated), (4) fair market value (if donated), (5) estimated life, and (6) disposition date.

In addition, some items on the property listing did not have asset tag numbers. The OIG judgmentally selected ten items to confirm physical existence. Although, all ten items were present, 5 of the items did not have a tag number placed on them for identification. Two of the items did not have a unique asset ID assigned to them.

RILS' property policies do not specify all of the property record fields mandated by Section 3-5.4, Cash Disbursements, Property Record as stated in the LSC's Accounting Guide. As such, the property records were not maintained in accordance with LSC's *Fundamental Criteria*.

Section 3-5.4 (c) of the LSC Accounting Guide provides that:

> Property purchases should be recorded in a property subsidiary record. The property record should include description of property, date acquired, check number, original cost, funding source, estimated life, depreciation method identification number and location.

The Executive Director stated that the new asset management system purchased in March 2015 is still being implemented and populated with data. Going forward, staff responsible for maintenance of the fixed assets listing intends to enter as much data as possible. The Executive Director said that the entire process would be updated to include all the required components on the fixed asset listing.

Failure to maintain adequate property records may result in the inability to fully account for the assets purchased and support reconciliations so that property asset balances are accurate. In addition, incomplete property and equipment record-keeping may result in loss of resources.

No Disposal Policy

RILS's property policies do not provide guidance on processes and procedures for disposal of property.

In discussion with the Executive Director, he explained that although the grantee does not have a written policy on disposing of property, they do have a practice in place. Occasionally, the grantee donates excess items, but more often items are trashed due to zero market value.

Based on our discussions and testing of the internal controls over fixed assets, we were able to verify that the grantee had an adequate practice in place to properly dispose of fixed assets.

Section 3-4, Internal Control Structure, LSC Accounting Guide states that:

> Each recipient must develop a written accounting manual that describes the specific procedures to be followed by the recipient in complying with the *Fundamental Criteria.*

Without detailed written policies and procedures, there could be a lack of transparency and consistency in the application of the reconciliation process, especially in cases of staff turnover. Furthermore, the grantee may incur losses due to improper disposal of property.

Recommendations: The Executive Director should:

Recommendation 7: ensure that a physical inventory is completed at each office location every two years and that the results are documented and reconciled to the property records and the general ledger;

Recommendation 8: ensure that assets are assigned unique asset identification numbers and tagged accordingly; and, that the fixed asset listing record is updated with all the required components set forth in the Accounting Guide;

Recommendation 9: enhance existing fixed assets policies and procedures to include guidance on disposal of property and ensure that they fully capture all the property record listing elements required by LSC's *Fundamental Criteria.*

MASTER VENDOR LIST

The OIG found that duties related to maintenance of the master vendor list and performing disbursement functions such as processing payments to vendors were not adequately segregated.

The Finance Officer is solely responsible for the maintenance of the master vendor list. Those responsibilities included adding vendors, editing vendor information and deleting vendors from the list. She is also the system administrator for the MIP fund accounting system used for processing payments made to vendors. The master vendor list and any activity associated with that list is not reviewed or approved by a higher level of management.

The Accounting Guide states:

> Accounting duties should be segregated to ensure that no individual simultaneously has both the physical control and record keeping responsibility for any asset, including, but not limited to cash, client deposits, supplies and property. Duties must be segregated so that no individual can initiate, execute, and record a transaction without a second independent individual being involved in the process.

The Finance Officer stated that since the grantee is small, they have not ascertained the need for another person to review the master vendor list. She also stated that since the Executive Director always reviews the disbursement checks before he signs them, there is little room for error.

Persons having dual responsibilities like maintenance of records and disbursing checks have increased chances of being involved in fraudulent activities that may go undetected. This could result in unauthorized vendors being set up to receive payments or address changes resulting in payments sent to incorrect locations.

Recommendation: The Executive Director should:

Recommendation 10: ensure that the duties of maintaining the master vendor list and processing payments to vendors are adequately segregated. The grantee could also consider requiring additional review of the master vendor list and all related edits and changes to the list by another authorized person on a periodic basis.

CREDIT CARDS

The OIG's review of the grantee's Accounting Manual determined that there are no written policies governing the use of credit cards. The grantee has one credit card, Staples Business Credit Card, with a credit limit of $2,500, which can only be used for purchases made from Staples. The Executive Director is the sole authorized user on the account. During our testing of disbursements, we tested transactions with the Staples Business credit card. In practice, all credit card transactions were adequately documented and approved.

The Finance Officer stated that due to a management oversight, there are no written policies for credit cards in the Accounting Manual.

The LSC Accounting Guide stipulates that a written policy with a description of specific procedures to be followed in complying with the *Fundamental Criteria* should be developed and recorded in the grantee's Accounting Manual.

Without adequate written policies over the use of credit cards, unauthorized transactions may be initiated resulting in the waste or misuse of financial resources.

Recommendation: The Executive Director should:

Recommendation 11: ensure that the Accounting Manual includes written policies and procedures over use of credit cards. It should list details such as spending limits, approval policies and controls over the issuance and use of credit cards.

COST ALLOCATION

The OIG reviewed the grantee's Accounting Manual and found no written cost allocation policies and procedures in the manual. However, the grantee does have a reasonable cost allocation methodology in practice, which we tested and found to be in accordance with the LSC *Fundamental Criteria*. The Executive Director acknowledged the deficiency and stated that the practiced cost allocation methodology will be included in the revised Accounting Manual.

The *Fundamental Criteria*, Section 3-5.9 (c), allocations, states:

> The allocation formula should be adequately documented in writing with sufficient detail for the auditor, LSC, OIG, GAO, and others, to easily understand, follow, and test the formula.

Approved, documented policies and procedures represent management's intention on how processes are to be handled and also serve as a method to document the design of controls to the staff and help the grantee ensure that proper controls are followed.

Recommendation: The Executive Director should:

Recommendation 12: ensure that the grantee's Accounting Manual is revised to include written cost allocation policies and methodologies to reflect the actual practice.

GRANTEE COMMENTS

Grantee management agreed with all findings in the report and accepted all 12 of the recommendations. With respect to the $481 in questioned attorney fees, RILS management prepared an adjusting entry moving those funds to LSC.

Also, the grantee requested that we change our reference to the “Rhode Island Supreme Court” to “Rhode Island Judiciary” in the background section.

OIG EVALUATION OF GRANTEE COMMENTS

The OIG considers the proposed actions to address Recommendations 1, 2, 3, 4, 5, 6, 10, 11 and 12 as responsive. The actions planned by grantee management to address the issues and revise and update its Accounting Manual should correct the issues identified in the report. We also updated the background section of the report to their suggested change of the “Rhode Island Judiciary.”

However, Recommendations 1, 2, 3, 4, 11 and 12 will remain open until the grantee has drafted the respective policies, revised its Accounting Manual and obtained the required Board of Director’s approval.

The grantee was not responsive to Recommendations 7, 8 and 9. These recommendations all related to fixed assets. The grantee did not address how they would ensure that all offices would be inventoried; that all assets were properly tagged with a unique ID number; and whether they would create an asset disposal policy. As such, all of these recommendations will remain open. The OIG is referring these recommendations to LSC management for resolution.

Recommendations 5 and 6 are considered closed. The new “General Procurement Determination Form” addresses the OIG’s concerns in the related finding. Recommendation 10 is also considered closed. The grantee has implemented a new procedure to address controls over the Master Vendor List.

The questioned cost referral for attorney fees will remain in effect until the OIG receives documentation verifying that the adjusting entry has been made.

APPENDIX I

SCOPE AND METHODOLOGY

To accomplish the audit objective, the OIG identified, reviewed, evaluated and tested internal controls related to the following activities:

- Derivative Income;
- Contracting;
- Cost Allocation;
- Fixed Assets;
- Internal Management Reporting and Budgeting;
- General Ledger and Financial Controls;
- Disbursements; and
- Payroll and employee benefits.

To obtain an understanding of the internal controls over the areas reviewed, grantee policies and procedures were reviewed including manuals, guidelines, memoranda and directives, setting forth current grantee practices. Grantee officials were interviewed to obtain an understanding of the internal control framework, and management and staff were interviewed as to their knowledge and understanding of the processes in place. To review and evaluate internal controls, the grantee's internal control system and processes were compared to the guidelines in the *Fundamental Criteria of an Accounting and Financial Reporting System* (*Fundamental Criteria*) contained in the LSC Accounting Guide. This review was limited in scope and not sufficient for expressing an opinion on the entire system of grantee internal controls over financial operations.

We assessed the reliability of computer generated data the grantee provided by reviewing available supporting documentation for review, conducting interviews and making physical observations to determine data consistency and reasonableness. We determined the data were sufficiently reliable for the purposes of this report.

Controls over derivative income were reviewed by examining current grantee practices and reviewing the written policies contained in the grantee's Procedures Guide. We interviewed appropriate program personnel and performed recalculations of some revenue accounts.

To evaluate the adequacy of the cost allocation process, we discussed the process for the scope period with grantee management and observed and tested the cost allocation policies and procedures for review as required by the LSC Accounting Guide.

We judgmentally selected four administrative employees whose salaries were allocated over different funding sources for testing of indirect salaries. We performed detailed testing to determine if allocations to LSC funds were appropriate. For testing of direct salaries that were paid in relation to work hours over specific programs, we selected and tested salaries of three attorneys and paralegals. Our testing corresponded to four pay periods in 2014 and 2015. We also tested cost allocations for other indirect costs such as rent, utilities and audit fees by reviewing such costs over two quarters using information provided by the grantee to determine if cost allocations to LSC funds were appropriate.

To evaluate and test internal controls over the contracting, fixed assets, internal management reporting and budgeting, general ledger and financial controls and payroll, we interviewed appropriate program personnel, examined related policies and procedures and selected specific transactions to review for adequacy. We performed detailed disbursements testing by judgmentally selecting a sample of 87 disbursements from 46 vendors. We reviewed supporting documentation, approvals and the appropriateness of each disbursement.

The on-site fieldwork was conducted from October 19 to October 27, 2015. Our work was conducted at the grantee's office in Providence, RI and at LSC headquarters in Washington, DC. We reviewed documents pertaining primarily to the period January 1, 2014 through August 31, 2015.

This audit was conducted in accordance with generally accepted government auditing standards. Those standards require that the audit be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. The OIG believes the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.