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REPORT OF INVESTIGATION

Case Number: 15-029 **Date: September 30, 2015**

Title: Subgrant Capstone Report

Status: Closed

PREDICATION

In 2012, the Office of Inspector General (OIG) opened criminal investigations concerning two Legal Services Corporation (LSC) approved subgrantees. The OIG investigations found evidence of theft of program funds through conflicts of interest, personal purchases, and misuse of payroll. The investigations also found that the involved LSC grantees provided inadequate fiscal oversight and as a result, were unaware of fiscal management issues at the subgrantees. One of the investigations is pending prosecution. The other investigation resulted in the conviction and incarceration of the subgrantee's former Executive Director.

As a result of these two OIG investigations, the OIG incorporated subgrant reviews as part of our Regulatory Vulnerability Assessments (RVAs) at selected LSC grantees in order to identify opportunities to reduce exposure to fraud by improving compliance with LSC regulations, including 45 C.F.R. Part 1627, Subgrants. During the RVA reviews, the OIG found instances where LSC grantees were not conducting adequate fiscal oversight of the subgrantees as required by Part 1627 and could not always verify that LSC funds were expended within the parameters of LSC regulations or within the terms of the LSC subgrant agreement.

OBJECTIVES

Due to the financial risks identified through criminal investigations and RVAs, the OIG initiated a Subgrant Review Project (SRP) to determine whether LSC funds were at risk for fraud, waste, and abuse. We also conducted this SRP to determine whether LSC funds were used on LSC restricted activities. The SRP also reviewed grantee/subgrantee compliance with LSC Regulations and the LSC subgrant approval process (Subgrant Agreement (Form A), New Subgrant Inquiries (Form B), and Renewal Subgrant Inquiries (Form C)).

Incorporated in this report are issues identified from the 20 subgrant reviews at 12 LSC grantees.[1]

[1] The 20 subgrants reviewed were part of the 12 grantees Private Attorney Involvement (PAI) requirement under 45 C.F.R Part 1614.

SUMMARY

The SRP found that grantees provided insufficient fiscal oversight of subgrantees. This lack of adequate oversight resulted in instances of non-compliance with Part 1627 and subgrant agreement terms; weak internal controls; inadequate or non-existent fiscal policies; and inconsistent fiscal reporting by subgrantees.

The table below summarizes the results of our field work which identifies potential weaknesses at the 20 subgrantees which could put them at risk to fraud, waste, and abuse:

Subgrantee	Internal Controls	Fiscal Policies	Grantee Oversight	Restricted Activity	Fidelity Bond Coverage
A			X		X
B			X	X	X
C			X	X	
D	X		X	X	
E	X		X	X	
F	X		X	X	
G					
H	X	X	X		
I			X		
J	X	X	X		
K	X	X			
L	X			X	X
M	X	X	X	X	
N	X	X	X		
O	X	X			
P	X	X	X		X
Q	X		X		
R	X	X	X	X	
S			X		X
T			X	X	X

FRAUD RISKS

LSC Regulation §1627.3(c) states that grantees shall be responsible for ensuring that subgrantees comply with the financial and audit provisions of LSC. This section further states that any funds delegated by a grantee to a subgrantee shall be subject to the audit and financial requirements of the Audit and Accounting Guide for Grantees and Auditors.

<u>Internal Controls and Fiscal Policies</u>

LSC Regulation Part 1627 requires subgrantees to comply with the requirements of the LSC Accounting Guide. The LSC Accounting Guide describes the accounting policies, records, and internal control procedures that should be maintained in order to ensure the integrity of accounting, reporting, and financial systems.

During the SRP review, the OIG found deficiencies in the implementation of subgrantees' accounting policies and procedures. For instance, some subgrantees did not have any written policies (Subgrantees H, P, and R). Also, some subgrantees were unaware of the LSC Accounting Guide, other subgrantees were unaware that the LSC Accounting Guide applied to subgrants, and other subgrantees requested more training on how to create a system of internal controls and policies in order to comply with the LSC Accounting Guide. As a result of the SRP, we found the following internal control weaknesses:

- Executive Directors obtained program credit cards without proper approvals (Subgrantees R, N, J, and K);
- Executive Directors used program credit cards for personal benefit (Subgrantees N, J, and K);
- Lack of documentation to support expenditures and credit card transactions (Subgrantees M, N, J, and K);
- Questionable early destruction of fiscal documents (Subgrantees M and K);
- Unsupported reimbursement payments to the Executive Director (Subgrantees M and J);
- Employees preparing and signing checks payable to themselves (Subgrantees J, L, and O);
- Lack of a sufficient accounting records including a general ledger (Subgrantee M and Q);
- Related party transactions with family members and paying for services exceeding the market rate (Subgrantee N); and
- Questionable travel and meal expenses (Subgrantees J and K).

<u>LSC Grant Assurance 15</u>

LSC Grant Assurance 15 requires grantees to report suspected issues of fraud exceeding $200 to the OIG within two business days. During the investigation of one subgrantee for allegations of fraud, the OIG discussed with the grantee staff their review of documents submitted by the subgrantee as proof of expenditures. Grantee staff, including the Executive Director, stated that several of the invoices submitted by the subgrantee appeared questionable. As a result of the questionable transactions, the grantee mandated that subgrant funds could only be used to pay staff salaries.

During a SRP visit in 2014, a grantee Executive Director advised the OIG that he suspected that the subgrantee's prior Executive Director embezzled funds and had possibly destroyed financial documents. The subgrantee Board fired the Executive Director in November 2011. The two grantees in question never notified the OIG of the potentially fraudulent transactions by subgrantee staff despite the requirement of Grant Assurance 15.

<u>Grantee Oversight</u>

LSC Regulation §1627.3(c) states that the grantees have the responsibility to ensure that subgrantees are complying with the fiscal requirements established by LSC but there is little guidance provided to grantees on how to fiscally oversee subgrantees. As a result, the OIG found that grantees provided limited fiscal oversight of subgrantees and generally relied on external auditors' annual audit of the subgrantees. LSC's subgrant forms require grantees to explain the type of oversight the grantee will conduct but does not require specific fiscal oversight measures or requirements. The OIG found that while most grantees conducted some oversight of LSC eligibility and case reporting requirements, they did not conduct adequate fiscal oversight to prevent fraud, waste, and abuse.

The SRP determined that ten of the 12 grantees provided insufficient fiscal oversight of their subgrantees. In addition, four of the grantees had no fiscal oversight policies for their subgrantees. Recent OIG investigations have shown the need for greater oversight of subgrantee expenditures by grantees. Grantees also need to ensure that subgrantees properly implement accounting policies and procedures.

The OIG found that prior to April 2012; a subgrantee did not document or keep invoices of how LSC funds were spent. Instead, random receipts that totaled the monthly subgrant payment were sent to the grantee. The grantee never questioned the type of allocation used by the subgrantee and was unaware that the subgrantee engaged in LSC restricted activities.

Another LSC grantee advised the OIG that it had not conducted an onsite visit to any of their three subgrantees in several years and quarterly timesheets submitted to the grantee were not reviewed. The grantee stated that the only fiscal oversight conducted was the review of the subgrantees' financial statements.

Also, another grantee was unaware that two of its three subgrantees did not have accounting manuals or procedures.

<u>Financial Statement Review and Associated Risks</u>

During the SRP, the OIG found instances where LSC funds were at risk due to the grantee's lack of review and attention to corrective actions reported on the subgrantee's financial statements. The OIG found that prior to 2012 some grantees did not review the subgrantees' financial statements. LSC requires subgrantees to have delegated funds audited and reported in the grantee's financial statement, a separate financial statement, or an alternative method stated in the subgrant agreement. LSC regulations and the subgrant agreements do not require review of the financial statements; however in subgrant Forms B and C, LSC asks whether grantee oversight includes the review of the subgrantee's financial statements. The SRP found some grantees did not review subgrantee financial statements and some did not notify LSC of subgrantees that had significant findings of fiscal weaknesses in their financial statements which could create a vulnerability to theft and misuse of LSC funds.

During the SRP, the OIG found that a subgrantee's 2010 financial statements were not completed until December 2011 due to fiscal mismanagement. During this time, the subgrantee was penalized over $90,000 by the Internal Revenue Service for nonpayment of payroll taxes. Also, the subgrantee's 2010 and 2011 financial statements had several significant and material weaknesses dealing with internal controls and the recordkeeping of federal grant monies. The subgrantee's Board of Directors and the grantee did not take action on these findings until 2012 by firing the Executive Director and the Bookkeeper. During the time of the SRP in 2014, the subgrantee was working to establish accounting policies consistent with the LSC Accounting Guide.

The SRP also identified measures taken by grantees to remedy fiscal weakness findings in subgrantee financial statements. During the OIG's review of a three subgrantees' 2011 financial statements, the auditors found that each of the subgrantees did not have adequate internal controls in place. The auditors also recommended hiring a qualified accountant and training current accounting personnel. The grantee responded to these issues by developing an extensive fiscal oversight policy for their subgrantees and conducted periodic training.

REGULATORY RISKS

Restricted Activity and Fidelity Bond Coverage

LSC Regulation 45 C.F.R. §1627.3(e) states that subgrantees are governed by the LSC Act, Congressional restrictions, LSC regulations, instructions, guidelines, and assurances. Section 1627.3(e) also states that the subgrant agreement between the grantee and the subgrantee must provide the same oversight rights for the subgrantee as applies to the grantee.

LSC Oversight Rights

Section §1627.3(e) permits LSC to have the same oversight rights for subgrantees as applies to grantees. As a result of the SRP, the OIG found that prior to 2012, LSC oversight of subgrantees appeared to be limited to review of client eligibility and case reporting requirements with little review of the fiscal oversight of subgrantees.

Application of other LSC Regulations and Restrictions

As stated in Section §1627.3(e), LSC subgrantees are bound by the same rules and regulations as LSC grantees, unless otherwise stated. The OIG review found a lack of adequate enforcement and training on LSC regulations and restrictions by LSC and the grantees resulting in a lack of understanding of LSC regulations and restrictions by the subgrantees.

LSC Regulation Part 1610: Program Integrity

Subgrantees and grantees that receive LSC funds under Part 1610, must agree that the non-LSC funds of the subgrantee are subject to LSC prohibitions and requirements specified in 45 CFR Part 1610, with the specific exception in Section 1610.7 for Private Attorney Involvement (PAI) transfers and the modification on priorities and timekeeping stated therein.

The SRP determined that nine out of 20 subgrantees engaged in LSC restricted activities. Out of the nine subgrantees, four subgrantees had not informed the grantees that they had engaged in LSC restricted activities. LSC subgrant application forms do not require subgrantees to state whether they have engaged in LSC restricted activities and LSC subgrant provisions do not require PAI subgrantees to have an allocation method that ensures LSC funds are only used to support LSC permitted activities nor do they require subgrantees to ensure that non-LSC funds are spent consistent with LSC restrictions.

The OIG found four grantees were not aware that their subgrantee(s) engaged in LSC restricted activities and did not conduct oversight to ensure that LSC funds and, where applicable, non-LSC funds, were not used to support the LSC restricted activities. In most of these instances, subgrantees assisted immigrants ineligible for assistance under 45 C.F.R. Part 1626, Restrictions on Legal Assistance to Aliens. The OIG also found that in the four instances where the grantee was unaware of the subgrantees' restricted work, LSC funds were used to pay salaries for employees that, among other duties, also assisted ineligible immigrants. During an RVA of a grantee, it was found that two of its three subgrantees held clinics and did not screen for citizenship or income. In both cases, LSC funds were used to pay the salaries of the employees conducting the clinics.

LSC Regulation Part 1629: Fidelity Bond Coverage

Any program which receives LSC funds is required by 45 C.F.R. 1629.1 to carry fidelity bond coverage at a minimum level of at least ten percent of the program's annualized LSC funding level for the previous fiscal year or the initial grant or contract. However, no LSC grantee shall carry less than $50,000 of coverage. During our review period (2011-2013) subgrantees were required to provide their own fidelity bond coverage to meet Part 1629. Under Form A of the subgrant application, LSC now allows grantees to extend their coverage to subgrantees.

Out of the 20 subgrantees reviewed by the OIG, six had deficiencies related to fidelity bond coverage. Two subgrantees did not carry any fidelity bond (Subgrantees P and T). Four subgrantees had fidelity bonds with insufficient coverage amounts (Subgrantees, A, B, L, and S).

RECOMMENDATION

LSC has continued to make improvements to assess and improve the fiscal competence of grantees during the grant application and review process. Based on the issues outlined in this Capstone Report, LSC should consider comparable improvements during the subgrant application and review process.

The issues found during the SPR highlight the need for improved subgrantee knowledge of the fiscal requirements stated in 45 C.F.R. 1627.3 and the need to provide specific guidance to grantees on the proper fiscal oversight of LSC funds at the subgrantee level. Incorporating into the subgrant application process more instruction regarding the fiscal responsibilities required by both the subgrantee and the grantee will improve fiscal competence and will help reduce their vulnerability to fraud. Some possible requirements for subgrantees and grantees include the following:

- Subgrantees submit their accounting manual and most recent financial statements to LSC for review prior to receiving LSC funds.
- Subgrantees disclose whether they engage in restricted activities during the subgrant application process.
- Subgrantees submit proof of fidelity bond coverage or acknowledgment that requisite bond coverage will be obtained during the subgrant application process.

- Grantees develop protocols to monitor subgrantee expenses in order to detect fraud and to ensure that funds are spent within the terms of the subgrant agreement.
- Grantees monitor corrections from findings of fiscal weaknesses reported on subgrantees financial statements.
- Grantees report to LSC and the OIG any suspected mismanagement and misuse of funds by subgrantees.

LSC Management Response to Subgrant Capstone Response:

As a result of the Subgrant Capstone Report, LSC Management announced on June 5, 2015, changes to the subgrant reporting and application process for 2016. For more details on the changes, follow the link below:

http://www.lsc.gov/subgrant-agreements-guidance

The OIG finds LSC's new guidance on subgrant reporting and application process for 2016 responsive to the recommendations in our Subgrant Capstone Report.