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Legal Services Corporation

Inspector General
Jeffrey E. Schanz

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March 26, 2014

Mr. Lance Daniels
Executive Director
Appalachian Research and Defense Fund of Kentucky
120 North Front Avenue
Prestonsburg, KY 41653

Dear Mr. Daniels:

Enclosed is the Office of Inspector General's (OIG) final report of our audit on Selected Internal Controls at Appalachian Research and Defense Fund. The OIG reviewed your comments to the draft report. Your comments, excluding the accounting guide, are included in the final report as Appendix II.

The OIG considers your comments responsive to the four recommendations. Since the actions implemented have fully addressed Recommendations 1, 2, and 4, we consider them as closed. However, Recommendation 3 will remain open until your Board of Directors approves the revised accounting guide and the OIG receives written notification thereof.

We thank you and your staff for your cooperation and assistance.

Sincerely,

Jeffrey E. Schanz
Inspector General

Enclosure

cc: Legal Services Corporation
Jim Sandman, President

Lynn Jennings, Vice President
for Grants Management

LEGAL SERVICES CORPORATION

OFFICE OF INSPECTOR GENERAL

REPORT ON FOLLOW-UP OF

Appalachian Research and Defense Fund of Kentucky

RNO 618030

Report No. AU14-02

March 2014

www.oig.lsc.gov

INTRODUCTION

The Legal Services Corporation (LSC) Office of Inspector General (OIG) conducted a follow-up audit on findings identified during a previous audit conducted at the Appalachian Research and Defense Fund of Kentucky, ("AppalReD" or "grantee") related to specific grantee operations and oversight. Audit work was conducted at the grantee's main office in Prestonsburg, Kentucky and at LSC headquarters in Washington, DC. A final audit report was issued on August 22, 2011 entitled Report on Selected Internal Controls at Appalachian Research & Defense Fund of Kentucky, Inc.
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

The OIG issued a Report on Selected Internal Controls at Appalachian Research & Defense Fund of Kentucky, Inc. Report No. AU11-05 on August 22, 2011. In that report, the OIG presented 12 findings, some with multiple issues, describing significant internal control and/or accounting weaknesses that needed to be improved by AppalReD's management. The control and accounting weaknesses identified led us to question the reliability of the information that we received and raised questions about integrity of the general ledger entries and account balances generated from the accounting system for the period under review and presented to us during the original audit. The OIG made one overall recommendation. The recommendation was for AppalReD's Board of Directors to obtain the services of a skilled individual, not associated with the grantee, to review and make all necessary changes to the internal control system, the accounting system, and the accounting department's organizational structure to ensure that the grantee's resources are properly controlled, accounted for, and safeguarded.

OBJECTIVE

The overall objective of this audit was to determine if the findings identified in the initial report had been corrected. This included determining whether the recommendation contained in the initial report was implemented and that the actions taken adequately addressed the deficiencies noted.

OVERALL EVALUATION

Overall, grantee management corrected most of the findings and related issues identified in the original audit report. AppalReD's Board of Directors did implement the audit recommendation. An experienced Fiscal Manager with an educational background in accounting and experience in managing an accounting department was hired and significant improvements were made to the grantee's internal control system, accounting system, and accounting department organizational structure.

Although the grantee had made significant progress in correcting the 12 findings, 4 findings were not fully addressed. Purchases over $500 were not processed in accordance with the grantee's accounting manual. The grantee's accounting manual did not address all areas required by LSC's *Fundamental Criteria.* The cost allocation system, though documented, was not the same as the allocation system in use. The grantee's property listing did not include all the required fields contained in LSC's *Fundamental Criteria*. The OIG considers all four of the issues presented above as repeat findings.

AUDIT FINDINGS

PURCHASES OVER $500

Of the ten purchases of goods and services over $500 reviewed, six did not have the required competitive quotes documented. The grantee did maintain documentation such as invoices and check copies which support the purchases. However, the OIG could not determine the basis for the six purchase decisions.

According to AppalReD's purchasing procedures, if the purchase price of an individual item is over $500[1], at least three quotes need to be obtained and documented. Published quotes in publicly available sources such as websites and catalogs may be used.

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[1] Although the $500 threshold may seem low, it was established by the grantee in designing its system of internal control. The main issue is following the controls established by management. Once a control is routinely ignored or overridden, the whole system of control is weakened and could give the impression that management does not see internal controls as important.

With respect to one of the purchases, the Fiscal Manager stated that the Executive Director made phone calls and obtained verbal quotes, but did not document the process. Discussions with the Fiscal Manager indicated that she had no explanation as to why the required quotes or sole source justifications were not maintained for the other nine purchases. However, if a purchase greater than $500 is made and the grantee management selects one vendor without obtaining quotes, there is no written policy requiring that a justification be documented and maintained on file.

Adhering to established policies and procedures helps ensure that the internal control system is functioning as designed and helps ensure assets are protected and effectively used. Also, the use of reasonable competitive methods helps reduce costs incurred by the grantee.

Recommendations: The Executive Director should:

Recommendation 1. Ensure that AppalReD employees follow established policies and procedures related to competition, and obtain and document quotes for purchases greater than $500.

Recommendation 2. Develop a policy requiring a written justification when a purchase for an item greater than $500 is made without obtaining the required number of quotes.

ACCOUNTING MANUAL

The grantee's accounting manual was updated in response to the OIG's original audit finding. However, five required policies are not included in the updated manual. Also, while a cost allocation system was documented in the grantee's accounting manual, it was not the allocation system in use.

Specific areas missing in the grantee's accounting manual were:

- Budgeting,
- Student Loan Repayment Assistance Program,
- Derivative Income,
- Travel, and
- Contracting.

OIG review of the grantee's cost allocation system disclosed that the system documented in the grantee's accounting manual was substantially different from what actually occurs in practice. The written policies state that expenses are charged directly to the programs based on the number of staff, while the grantee's practice indicates that the expenses are split between two accounts, LSC and Kentucky Filing fees, based on revenues. At the time of our audit, there was a 50-50 split.

The Fiscal Manager stated that she was not aware some of these areas needed to be in the accounting manual. However, grantee management stated that they were revising the current manual and are incorporating changes suggested by LSC's Office of Compliance and Enforcement.

To maintain an adequate internal control structure, each recipient must develop a written accounting manual that describes the specific procedures to be followed by the grantee in complying with the *Fundamental Criteria* contained in LSC's Accounting Guide (chap. 3-4, pg. 24). Written policies and procedures are vital to a strong control structure by helping ensure that proper controls are designed and communicated to all staff and that staff understand their roles and responsibilities.

Recommendation 3. The Executive Director should ensure that the Fiscal Manager updates the grantee's accounting manual to include all the above noted policies and procedures and to reflect the current cost allocation practice in place.

PROPERTY

AppalReD's inventory listing from some of the branch offices did not contain all the elements suggested by LSC's *Fundamental Criteria*. Some of the property listings were missing elements such as the check number, funding source and tag number.

According to LSC's *Fundamental Criteria*, property purchases should be recorded in a property subsidiary record. The property record should include the following fields:

- description of the property,
- date acquired,
- check number,
- original cost,
- fair value (if donated),
- method of valuation (if donated),
- salvage value, if any,
- funding source,
- estimated life,
- depreciation method,
- identification number (tag number), and
- location.

According to discussions with the Fiscal Manager, the recording of physical inventory was performed by email and over the phone due to time restrictions. As such, she stated that they did not have time to completely fill in all the required missing elements.

Maintaining adequate property records helps ensure the grantee fully accounts for fixed asset purchases, protects assets from loss or misuse, and supports depreciation amounts and property asset balances used for financial reporting.

Recommendation 4. The Executive Director should ensure that all key elements suggested in LSC's *Fundamental Criteria* are included on the grantee's property listing.

SUMMARY OF GRANTEE MANAGEMENT COMMENTS

Grantee management agreed in principle with all the findings and recommendations contained in the report. The Executive Director has required staff to document quotes for purchases greater than $500 and follow policies and procedures related to competition. Grantee management has developed a policy requiring written justifications when purchases greater than $500 are made without the required number of quotes. This new policy is included as part of their response. Grantee management has revised their accounting manual to include the noted policies and procedures in the OIG draft report. Those revisions were approved by the grantee's Board of Directors on December 7, 2013. Policies and procedures for the Student Loan Repayment Assistance Program (LRAP) and Budgeting were not revised during the December 7, 2013 Board meeting, but will be submitted for approval at the next Board meeting. The grantee also included an updated accounting manual as part of their response. Lastly, the Executive Director ensured that all key elements suggested in LSC's Fundamental Criteria are included in their property listing. The updated property listing was submitted along with their response. A copy of the grantee's response, minus the accounting manual, is included as an appendix to this report.

OIG EVALUATION OF GRANTEE MANAGEMENT COMMENTS

The OIG considers management's comments responsive to the findings and recommendations contained in the report. The grantee's corrective actions requiring staff to obtain and document quotes for purchases greater than $500, and the development of a written policy addressing purchases greater than $500 made without the required number of quotes, fully addresses Recommendations 1 and 2 in the report. The grantee also has fully addressed Recommendation 4 by updating their property list to contain all the key elements suggested in LSC's *Fundamental Criteria*.

As such, the OIG considers three of the four recommendations closed. However, Recommendation 3 is only partially addressed by the grantee's revisions to the accounting manual. Until policies and procedures related to LRAP and budgeting have been revised and approved by the grantee's Board of Directors at their next Board meeting, this recommendation will remain open.

APPENDIX I

SCOPE AND METHODOLOGY

To accomplish the audit objective, the OIG reviewed the 12 findings, representing 29 issues, contained in the original report. The 12 finding areas are listed below.

- Disbursements/purchasing
- Credit Cards
- Travel Expenses
- Unrecorded Expenses
- The Accounting Manual
- Budgeting and Internal Reporting
- Cost Allocation
- Employee Benefits (employee loans and LRAP)
- Consulting Contracts
- Vehicle Management
- Property Management
- Accounting Function and Organizational Structure

To determine whether the grantee had addressed the findings, policies and procedures were reviewed--including manuals, guidelines, memoranda, and directives setting forth current practices. Documentation supporting management's corrective actions was examined. Grantee officials were interviewed to obtain an understanding of the internal control framework and management staff were interviewed as to their knowledge and understanding of the processes in place. Internal controls were tested.

To test for the appropriateness of expenditures and the existence of adequate supporting documentation, we reviewed disbursements from a judgmentally selected sample of employee and vendor files. The sample represented 2.11 percent of the approximately $6.9 million disbursed for expenses other than payroll during the period January 1, 2012 to August 31, 2013, and consisted of 43 transactions totaling $148,008.21. We reviewed invoices, vendor lists, and traced expenditures to the general ledger. The appropriateness of grantee expenditures was evaluated on the basis of the grant agreements, applicable laws and regulations, and LSC policy guidance.

This review was limited in scope and the OIG's focus was only on those findings presented in the original report. We assessed the reliability of computer generated data provided by the grantee by reviewing source documentation for the entries selected for review. In the prior audit report we deemed that the data was unreliable. However, the grantee has made significant improvements to the extent that now we believe that the data used is sufficiently reliable for the purposes of this report.

This review was limited in scope and was not sufficient for expressing an opinion on the entire system of grantee internal controls over financial operations.

The on-site fieldwork was conducted at the grantee's main office in Prestonsburg, KY from September 23, 2013 to September 27, 2013. Documents reviewed pertained to the period January 1, 2012 to August 31, 2013. The remainder of our work was conducted at LSC headquarters in Washington, DC.

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.

APPENDIX II

APPALACHIAN RESEARCH AND DEFENSE FUND OF KENTUCKY, INC.

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March 21, 2014

Mr. Ronald D. Merryman,
Assistant Inspector General for Audit
Office of Inspector General
Legal Services Corporation
3333 K Street, NW, 3rd Floor
Washington, DC 20007-3558

Re: Response to Draft Report on Follow-Up, RNO 618030
Report No. AU14-XX – February 2014

Dear Mr. Merryman:

The following is our Response to the LSC Office of Inspector General Draft Report on Follow-up, Report No. AU14-XX:

Recommendation 1: Ensure that AppalReD employees follow established policies and procedures related to competition, and obtain and document quotes for purchases greater than $500.

Response to Recommendation 1: The Executive Director has required staff to follow the policies and procedures in place related to competition, and has directed staff to document quotes for purchases greater than $500.

Recommendation 2: Develop a policy requiring a written justification when a purchase for an item greater than $500 is made without obtaining the required number of quotes.

Response to Recommendation 2: Policy has been revised and a copy has been attached hereto.

Recommendation 3: The Executive Director should ensure that the Fiscal Manager updates the grantee's accounting manual to include all the above noted policies and procedures and to reflect the current cost allocation practices in place.

Response to Recommendation 3: The Executive Director has directed the Fiscal Manager to revise our Accounting Manual to include the noted policies and procedures included in the OIG's Draft Report. The Fiscal Manager has revised our Accounting Manual and those revisions were approved by the Board on December 7, 2013. A copy of the Accounting Manual is attached hereto. The Student Loan Repayment Assistance Program and Budgeting Policies were not revised during the December 7, 2014, Board meeting, but will be revised and submitted for approval by the Board at our next regularly scheduled Board meeting.

Recommendation 4: The Executive Director should ensure that all key elements suggested in LSC's Fundamental Criteria are included on the grantee's property listing.

Response to Recommendation 4: The Executive Director has ensured that all key elements suggested in LSC's Fundamental Criteria have been included on our Property Listing. Attached hereto is the updated Property Listing.

Submitted this the 21st day of March, 2014.

Lance A. Daniels

Lance A. Daniels,
Executive Director

PURCHASING PROCEDURES

AppalReD has developed and put into place a purchase order system and this should be used as a reference source to answer basic questions regarding purchasing procedures. Inevitably, questions will arise and exceptional circumstances will come up that are not covered here. When this occurs call or email the Chief Fiscal Officer for clarification. Proper use of the P.O. system provides an accurate record of products and services that have been requested.

When To Use A Purchase Order

A Purchase Order number must be obtained for all purchases of products or services other than Litigation Expenses, Personal Reimbursements such as travel expenses, re-occurring office expenses (such as rent, utilities and telephone) or Petty Cash (used for incidental expenses under $50).

Procedures to Follow

1. The person responsible for placing orders for products or services in the individual offices will complete a Requisition For Supplies.
2. The Requisition For Supplies needs to be signed by the individual completing the request and signed by the Director of the individual office (such as the DA, Pro-Bono Coordinator, ED, or Deputy Director) giving authorization for their staff to submit the request for purchase of products or services for the individual office.
3. Once the Requisition For Supplies has been completed and signed, call the Executive Assistant in the Administrative Office to obtain a Purchase Order Number and enter the Purchase Order Number assigned, on the Requisition For Supplies, located at the bottom of the form on the line that is labeled P.O. No.
4. After receiving and entering the Purchase Order Number on the Requisition For Supplies, send (scan, fax, mail, email) the form to the Executive Assistant.
5. The Executive Assistant will complete the assigned Purchase Order and obtain all necessary levels of approval for the purchase of products or services.
6. The Executive Assistant will scan a copy of the completed Purchase Order to the individual office for their records.
7. The Executive Assistant will maintain a log of all Purchase Orders issued and the *original* copies placed in a binder.
8. The Executive Assistant will forward the *yellow* copy of the Purchase Order to the Support Staff Coordinator to place the order for the product or service if the order is to be placed by the Administrative Office.
9. The Executive Assistant will forward the *pink* copy of the Purchase Order to the Assistant Fiscal Officer.
10. The Assistant Fiscal Officer will maintain a file with all outstanding Purchase Orders.
11. When the shipment of products or services is received at the individual offices, staff checks the order received to the packing slip. Sign the packing slip verifying that the actual amount received was the amount recorded on the packing slip. Forward the packing slip to the Assistant Fiscal Officer (Accounts Payable Department).

12. When the Assistant Fiscal Officer receives an invoice for payment, the copy of the Purchase Order, Requisition For Supplies, the packing slip and any other supporting documentation are attached to the invoice before payment is made.

Do I Need a Purchase Order for Wal-Mart Credit Card purchases?

Yes. As stated on the previous page, a Purchase Order and Requisition For Supplies must be obtained for all purchases of products or services other than Litigation Expenses, Personal Reimbursements such as travel expenses, re-occurring office expenses (such as rent, utilities and telephone) or Petty Cash (used for incidental expenses under $50).

Do I Need To Get Quotes?

If the purchase price of an individual item is over $500, there needs to be documentation of at least three comparable quotes. Published quotes in publicly available sources such as website and catalogs may be used. Property purchases in an amount of $10,000 for a single item to be acquired with LSC funds will require that the program follow LSC bidding and purchasing policies. If you are unable to obtain documentation of the three required quotes or unable to obtain the required number of quotes, a written justification needs to be submitted stating the reason for the deviation from the purchasing policy.