Office of Inspector General
Legal Services Corporation

Inspector General
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December 07, 2015

Ms. Jessie Nicholson
Southern Minnesota Regional Legal Services
1000 Alliance Bank Center
55th East Street
St. Paul, MN 55101

Dear Ms. Nicholson:

Enclosed is the Office of Inspector General's (OIG) final report for our audit of Selected Internal Controls at Southern Minnesota Regional Legal Services. The OIG has reviewed your comments on the findings and recommendations in the draft report. Your comments are included in the final report as Appendix II.

The OIG considers your actions taken and planned actions responsive to all of our recommendations. Recommendations 1, 2, 3, 4, 5, 6, 7, 8, 9, 11, 12 and 13 are still considered open until the OIG is notified in writing that the accounting manual is updated and the planned actions have been completed and implemented. Recommendations 10 and 14 are considered closed.

The OIG is referring $21,248 in questioned costs to LSC Management for their determination. These costs involve SSI reimbursements and rental income received by SMRLS that were not allocated to LSC.

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

Sincerely,

Jeffrey E. Schanz
Inspector General

Enclosure

LSC
America's Partner For Equal Justice

cc: Legal Services Corporation
Jim Sandman, President

Lynn Jennings, Vice President
For Grants Management

Southern Minnesota Regional Legal Services
J. Scott Braden
Board Chairperson

Sent by E-mail to Board of Directors
Gail Olson
Matt Benda
Tom Hatch
Kari Valley
Drew Baese
Kathy Bartz
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Tim Connell
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Suyapa Miranda
Terry Newby
Brett Olander
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Brett Strand
Jon Oviatt

LEGAL SERVICES CORPORATION

OFFICE OF INSPECTOR GENERAL

FINAL REPORT ON SELECTED INTERNAL CONTROLS

SOUTHERN MINNESOTA REGIONAL LEGAL SERVICES, INC.

RNO 524030

Report No. AU 16-03
(Formerly 16-04)

December 2015

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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 Southern Minnesota Regional Legal Services, Inc. (SMRLS or grantee) related to specific grantee operations and oversight. Audit work was conducted at the grantee's administrative office in Saint Paul, MN 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

SMRLS is a not-for-profit corporation whose mission is to provide a full range of high quality legal services to low-income persons and eligible client groups in civil matters, in a respectful manner which enables clients to (1) enforce their legal rights; (2) obtain effective access to courts, administrative agencies and forums which constitute the system of justice; (3) maintain freedom from hunger, homelessness, sickness and abuse; (4) empower persons and assure equal opportunity, thus, helping people to help themselves and become economically self-reliant, to the extent their individual abilities and circumstances permit. The grantee provides help in civil legal matters with a focus on helping clients secure and protect basic needs. Each year, staff and volunteers close approximately 10,000 cases, serving an additional 20,000 people through community education and outreach activities. SMRLS currently serves the 33 counties of southern Minnesota, including the Twin Cities' east and south metro, as well as agricultural workers throughout Minnesota and North Dakota. The grantee has 9 offices: two in St. Paul, Albert Lea, Mankato, Rochester, Moorhead, Shakopee, Winona and Worthington, MN.

According to the audited financial statements for the grantee's year ended December 31, 2014, approximately 25 percent of the grantee's total funding was provided by LSC. SMRLS received $7,512,566 in total revenues and support (excluding donated services) of which $1,863,737 was grant income from LSC.

OBJECTIVE

The overall objective was to assess the adequacy of selected internal controls in place at the grantee as the controls related to specific grantee operations and oversight, including program expenditures and fiscal accountability. Specifically, the audit evaluated selected 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 internal controls related to derivative income, cost allocation, contracting, property, internal reporting & budgeting, general ledger & financial controls, disbursements, credit cards, payroll and employee benefits.

While many of the controls were adequately designed and properly implemented as they related to specific grantee operations and oversight, some controls need to be strengthened and formalized in writing. The OIG identified the areas listed below that need improvement.

DERIVATIVE INCOME

The OIG determined that SMRLS did not allocate any State Supplemental Security Income (SSI) reimbursements to LSC during the period under review. Also, rental income received from a sublease was not allocated to LSC.

State Supplemental Security Income Reimbursements

SMRLS received $79,950 in state SSI reimbursements during the period under review, of which $18,250 allocable to LSC was not duly credited back to LSC. The State SSI reimbursements received by the grantee during the audit period were allocated in their entirety to the unrestricted fund even though the effort to represent the clients was charged to LSC.

According to 45 CFR §1630.12, 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 grantee's LSC grant is recorded, in the same proportion that the amount of LSC funds expended bears to the total amount expended by the grantee to support the activity.

The grantee has no policy with regard to derivative income and is not aware of LSC's derivative income requirements. Since State SSI reimbursements were not allocated to LSC in accordance with 45 CFR §1630.12, the OIG is questioning $18,250 of State SSI reimbursements. The OIG will refer the questioned derivative income to LSC management for review and action.

Rental Income

SMRLS earned rental income of $7,800 during the audit period from subleasing a portion of the office space at its Mankato office. Based on the OIG's analysis of the grantee's indirect expenses, it was determined that the grantee used LSC funds to pay approximately 38 percent of the rental expenses, but did not allocate rental income received from the sublease back to LSC. As a result, the grantee did not appropriately allocate a proportional amount of income to LSC.

Based on the OIG's estimate of the portion of rent paid by LSC, approximately $2,998 in rental income earned on that property should have been allocated back to LSC as derivative income.

As stated above, the grantee has no policy on derivative income and in general was not aware of LSC's derivative income requirements. Properly recording derivative income allows LSC to be allocated its apportioned share, which in turn can be used to provide legal services in accordance with LSC requirements.

Since rental income was not allocated to LSC in accordance with 45 CFR §1630.12, the OIG is questioning $2,998 of rental income for the sublease of office space at the Mankato office. The OIG will refer the questioned rental income to LSC management for review and action.

Recommendation 1: The Executive Director should ensure all derivative income adheres to the requirements stated in 45 CFR §1630.12 and the requirements detailed in LSC's Accounting Guide, Section 2-2.7.

ACCOUNTING MANUAL UPDATES

Many of the written policies and procedures in the grantee's Accounting Manual do not reflect practices currently in place and followed by the grantee. Various written policies and procedures were missing from the manual. Some of the written policies and procedures in the accounting manual did not contain all the key elements required by the *Fundamental Criteria of an Accounting and Financial Reporting System (Fundamental Criteria)* contained in the LSC Accounting Guide. Below are the areas that need to be addressed in the grantee's Accounting Manual.

Contracting

The grantee's Accounting Manual does not include policies and procedures on identifying the various types of contracts, dollar thresholds and processes and procedures to administer contracts. It also does not include details on the processes involved in competitive bidding and selection of vendors.

Section 3-5.16 of the LSC Accounting Guide stipulates that the grantee's formal policies should identify the contracting procedures for the various types of contracts, dollar thresholds and competition requirements to be followed by the recipient in complying with the *Fundamental Criteria.* It also requires the maintenance of documentation for contract action.

The Controller stated that documentation of contract action was not maintained because it is not required by the requirements stated in the SMRLS Accounting Manual.

Proper documentation helps ensure that the approved contracts have followed all established procedures. Contracting is a high risk area for potential abuse. Also, weak contracting procedures can result in the waste of scarce funds and subject the grantee to questioned costs proceedings.

Cost Allocation

SMRLS's Accounting Manual does not include policies and procedures on cost allocation. The grantee has a practice in place, but that practice is not based on a rational and systematic methodology and is subjective based solely on the Controller's judgment.

Section 3-5.9 (c), Allocations, of the LSC Accounting Guide stipulates that common expenses shall be allocated among the sources on the basis agreed to by the funding organizations. The allocation formula should be adequately documented in writing.

The OIG's discussions with the Controller revealed that the cost allocation policies are not included in the accounting manual because the grantee does not follow a pre-determined policy. The Controller was not able to identify a specific reason for the inconsistency in applying cost allocations.

Without detailed written procedures, there could be lack of transparency and consistency in the application of the methodology, especially in cases of staff turnover. Approved, documented policies and procedures represent management's intentions on how processes are to be handled and also serve as a method to document the design of controls, communicate the controls to the staff and help ensure that proper controls are followed.

Derivative Income

The grantee's Accounting Manual has no written policy on derivative income and attorney fees. Derivative income was not allocated back to the funding source from which the funds were expended and the grantee has no practice in place related to this area. Also, the grantee collected only one attorney fee during the audit period and the whole amount was allocated to LSC.

According to 45 CFR §1609.6, each grantee shall adopt written policies and procedures to guide staff in complying with this part and maintain records to document the recipient's compliance.

The grantee's management stated that they were not aware of derivative income recording requirements as stated in 45 CFR §1609.6.

Property

The grantee's Accounting Manual does not have policies and procedures for disposal of assets and tracking of property and equipment. Also, it does not include information on prior approval requirements from LSC for purchases of over $10,000 made with LSC funds. Furthermore, the Accounting Manual does not outline policies with regard to the frequency of physical inventory counts nor does it state that property records should be maintained with the fields required by LSC *Fundamental Criteria*. The grantee's inventory practices and property records documentation are not in accordance with LSC's *Fundamental Criteria.*

The LSC Accounting Guide states that each grantee must develop a written accounting manual that describes the specific procedures to be followed by the grantee in complying with the *Fundamental Criteria*.

Internal Reporting & Budgeting

The written policies for internal reporting & budgeting are not up-to-date and do not reflect the current practices of SMRLS. The budgeting process in practice seems to be reasonable and in accordance with the LSC *Fundamental Criteria.* The SMRLS Accounting Manual should be updated to reflect the differences as to when the budget process will start, be reviewed and approved by the Board of Directors. Due to the changes in the fiscal year, the Accounting Manual should also be updated to reflect the current newly created budget reports such as Actuals, Current Year Budgets, Comparison of Prior Year and Actuals etc., and remove reports such as Cash Receipts report and Payroll Activity report that are no longer being created in practice, but included in the manual.

Debit Card

The grantee's Accounting Manual does not have policies and procedures governing issuance and use of the single debit card. The card was used only twice over the audit scope period and the practices related to its issuance and use appear to be adequate and in accordance with LSC's *Fundamental Criteria*.

SMRLS's Chief Operating Officer and Controller together stated that the organization did not want to publicize the availability of the debit card for staff use and therefore decided not to establish a written policy.

Disbursements

Although the grantee's Accounting Manual includes policies and procedures for various disbursement operations, it could be enhanced and updated to reflect the current disbursement processes. The current policies on disbursements do not include written policies for setting up and deactivating electronic payments within the accounting system and on vendor portals. The Accounting Manual also does not include policies for governing blanket approvals.

The Controller explained that many processes have changed due to the new accounting software, NetSuite, and have yet to be incorporated into the Accounting Manual.

General Ledger and Financial Controls

OIG's review of G/L and financial controls in the grantee's Accounting Manual and other documented policies such as Bank & Investment Account Reconciliations, Electronic Banking, Accounts Payable & Cash Disbursements and Cash Receipts policies determined that SMRLS's policies mostly adhered to LSC's *Fundamental Criteria, Sections 3-5-2 & 3-5-4*. However, there were no policies on the handling of outstanding checks, physical safeguarding of petty cash and documentation of the separation of LSC vs. non-LSC funds.

Without detailed written procedures, there could be a lack of transparency and consistency in the application of the methodology especially in cases of staff turnover. Approved documented policies and procedures represent management's intentions on how processes are to be handled and also serve as a method to document the design of controls, communicate the controls to the staff and help the grantee ensure that proper controls are followed.

The Controller stated that the grantee is aware their Accounting Manual is outdated and that they are planning to update the manual to reflect all the practices in place and include all information as required by LSC *Fundamental Criteria*.

Recommendation 2: The Executive Director should evaluate SMRLS's Accounting Manual to ensure that it is updated to reflect their current practices in place in the areas identified above and any other areas that are not adequately presented in accordance with requirements stated in the LSC *Fundamental Criteria.*

CONTRACTING

The OIG examined SMRLS's business arrangements during the audit period and determined that the grantee's contracting practices did not fully adhere to LSC guidelines and, in some instances, to the grantee's Accounting Manual.

Contracting Practices

The LSC OIG judgmentally selected nine contracts to test. Among the nine contracts selected for testing, one contract that was subject to competitive bidding was missing documentation of proof that the contract was competitively bid. The grantee was also not able to provide us with documentation for the selection process for one contract and another contract for janitorial services was not documented in writing.

The LSC *Fundamental Criteria* stipulates that the documents to support competition should be retained and kept with contract files. Further, it states that the process used for each contract action should be fully documented and the documentation maintained in a central file and that any deviations from the approved contracting process should be fully documented, approved, and maintained in the contract file.

SMRLS's Controller stated that since the SMRLS Accounting Manual did not stipulate maintenance of documentation for contract actions, none of the documentation for vendor selection process or contract action was required to be maintained. Apparently they were not aware of LSC requirements.

Contracting is a high-risk area for potential abuse. If not properly implemented, weak contracting practices can result in a waste of scarce funds and subject the grantee to questioned cost proceedings. Without a formal contract, the statement of work along with other contract terms cannot be adequately communicated or monitored, which may obstruct management's ability to prevent or detect the risk of fraud, waste and abuse. Proper documentation helps ensure that the contract has followed all established procedures.

Recommendations: The Executive Director should:

Recommendation 3: ensure that all documentary support is maintained for every contract action including documenting the competitive bidding process and vendor selection process such that they address the elements required by the *Fundamental Criteria* for documentation and approval requirements.

Recommendation 4: ensure that all contracts are documented and maintained in a central file. In addition, the statement of work should be sufficiently detailed so that contract deliverables can be identified and monitored to ensure that the deliverables are completed.

COST ALLOCATION

Allocation of Indirect Costs

The OIG reviewed SMRLS's cost allocation practices and found that the grantee did not have any set written policy for cost allocation in their Accounting Manual. The cost allocation methodology policy they follow does not outline how indirect costs should be allocated among the various funding sources. The Controller stated there was no set basis for allocating indirect costs to a particular funding source. The OIG determined that the costs are subjectively assigned to the funding sources based on her judgment on the availability of funds. The Controller also stated that most of the indirect costs are allocated to the Minnesota state appropriations fund.

When invoices are received by the grantee, the accountant codes the expenses based on the Chart of Accounts and enters them into the system. The Controller reviews the posting with the codes to ensure that the appropriate funding sources are charged with the expenses. The Controller stated that the staff are aware of restrictions imposed by LSC funds and therefore do not charge LSC with expenses that are unallowable by LSC. SMRLS's written cost allocation methodology does not address allocation of indirect expenses. The Controller stated that 80 percent of indirect costs are those of personnel salaries. The remaining 20 percent are non-personnel costs and all are allocated to operational grants such as LSC and State Appropriations grants. LSC funds provide about 25 percent of the grantee's grant revenues. The OIG determined, through testing, that approximately 22 percent of indirect costs were charged to LSC in total (26.11 percent in the first quarter of 2015 and 18.68 percent in the last quarter of 2014). The OIG determined the amount charged to LSC does not appear to be excessive and is in accordance with 45 CFR §1630.3 (e).

Section 3-5.9 stipulates that common expenses should be allocated among the funding sources on the basis agreed to by the applicable funding organizations, and in the absence of approved methods the allocation should be fair, consistent and apportioned in an equitable manner to the individual cost centers and funds. Further, 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. The allocation methodology should be reviewed and assessed as to whether it fairly represents the total cost of the activity.

The allocation of a cost to an activity must demonstrate the total cost of the activity that a funding source is financing. For regulatory bodies to follow the allocation easily, it should be reasonably allocated and appropriately documented.

Recommendation 5: The Executive Director should develop a cost allocation policy and methodology which is consistent with the requirements of 45 CFR §1630.3(e) and ensure that the policy is documented in the grantee's Accounting Manual.

PROPERTY

The OIG reviewed the grantee's internal controls over fixed assets and determined that some areas were not in accordance with the LSC *Fundamental Criteria*.

Physical Inventory

The grantee does not perform a physical inventory once every two years as required by LSC's *Fundamental Criteria* for capitalized assets. Also, they do not have a specific timeframe as to when they perform a physical inventory of electronic devices and other computer related items as required by SMRLS Property and Equipment policy. The Chief Operating Officer stated that the most recent physical inventory of fixed assets was conducted in the winter of 2014.

The Chief Operating Officer also stated that the assets were very old with no market value and management would know if any assets were to go missing. Therefore, management felt no need to do an inventory once every two years.

Section 2-2.4 stipulates that, for property control purposes, a physical inventory should be taken and the results reconciled with the property records at least once every two years. Any differences between quantities determined by the 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 grantee's auditor. The SMRLS Accounting Manual's Property and Equipment Inventory policy requires an inventory of all property and equipment be maintained and that the inventory document contain sufficient information for insurance and grant requirements.

Not conducting a physical inventory of fixed assets and electronic devices may result in the inability to fully account for the assets.

Fixed Asset Listing

The OIG selected a sample of eight items consisting of five electronic devices and three fixed assets, from the list of 113 fixed assets and tested them to determine if these items are properly accounted for.by the grantee. The OIG determined that the fixed asset listing is not up-to-date and missing fields such as salvage value, estimated life, and depreciation method. None of the three items tested could be located. Also, with respect to electronic devices, some of the users listed on the asset listing no longer worked for SMRLS.

SMRLS's Chief Operating Officer stated that he did not update all the fields on the fixed asset listing because the items were very old and carried no value.

The SMRLS Technology Manager stated that the laptop assignment list was not updated with the serial numbers of the electronic devices when the initial setup was done. She was not able to identify a specific reason for the assignment list.

LSC's *Fundamental Criteria,* Section 3-5.4 (c) requires property records to include details of property such as description, date acquired, original cost, funding source, estimated life, depreciation, location etc. The SMRLS Accounting Manual stipulates maintenance of an inventory listing of all property and equipment; further, it stipulates that this inventory listing should contain sufficient information for insurance and grant requirements.

Inadequate fixed asset listing and laptop assignment listing could result in:

- difficulty in tracking items with no serial numbers or user identification;
- items being misplaced; and
- items not being accounted for because of listing the incorrect user in the log.

Without an adequate and complete laptop assignment listing, there is no assurance that the grantee is properly safeguarding the equipment and information contained therein.

Recommendations: The Executive Director should:

Recommendation 6: ensure that a physical inventory of all fixed assets and electronic devices is performed every two years and the results are reconciled with the property records in accordance with LSC's *Fundamental Criteria*.

Recommendation 7: strengthen practices by updating the fixed asset and laptop assignment listings with adequate information in accordance with LSC Accounting Guide's 3-5.4(c), *property records* and the SMRLS Accounting Manual.

INTERNAL REPORTING AND BUDGETING

Untimely Monthly Reports

The Controller stated that the monthly management report, Month-To-Date Income Statement, is not being prepared in a timely manner. The Executive Director reviews and uses the monthly reports and they are sent to the Finance Committee.

Section 3-5.9 (a) stipulates that the Executive Director should receive a monthly management report within a prescribed number of days after month-end and verify the reports were completed each month on a timely basis.

The Controller stated she was trailing behind in preparing the internal reports because it takes her a month to close out the books.

Untimely management reports may result in erroneous decision-making on the part of management and the governing body.

Recommendation 8: The Executive Director should ensure that the Controller is preparing the monthly reports in a timely manner in accordance with LSC's *Fundamental Criteria.*

GENERAL LEDGER AND FINANCIAL CONTROLS

The OIG auditors randomly selected a sample of 15 monthly bank reconciliations of the operating accounts, repurchase accounts, client trust accounts and petty cash accounts at various SMRLS offices over the audit period for review to ensure that bank reconciliations were performed and reviewed in a timely manner and also determine if there were any checks outstanding for more than six months.

Bank reconciliations and outstanding checks

The OIG determined that:

- Of the 15 bank reconciliations sampled, eight were not performed monthly;
- On six of them, we could not determine when the reconciliations were performed because there were no dates next to the signatures;
- Three of them were not reviewed in a timely manner;
- Nine of them did not show approvals;
- One of them was not approved in a timely manner; and
- Four of the bank reconciliations had checks outstanding for over six months.

Section 3-5.2 (d) of the LSC Accounting Guide stipulates that reconciliation of bank statements to the general ledger should be performed monthly by persons independent of cash keeping duties, check signing duties and cash bookkeeping duties. The reconciliation procedure is a fundamental control technique and failure to use it is an internal control weakness, especially in an environment where full segregation of duties is not practicable. The LSC Accounting Guide, Appendix VII also stipulates that grantees investigate and resolve reasons for checks outstanding over six months.

SMRLS's Accounting Manual states that bank statements should be reconciled by the AP bookkeeper on a monthly basis, no more than one week after receipt of the statement. It further states that the reconciliation file should be forwarded to the CEO for review and approval.

Management stated that the six petty cash accounts and the two client trust accounts had low activity and were immaterial; therefore, quarterly reconciliations were performed. Management also stated they do not have a formal policy detailing the procedures in handling outstanding checks.

Delinquent or inaccurate reconciliation represents a lack of adequate control over financial transactions and increases the possibility that irregular transactions will be undetected or accountability for funds that may be lost. Monitoring outstanding checks is a reconciliation procedure that will substantially increase the likelihood of discovering irregular disbursements and recording errors on a timely basis.

Petty Cash

The OIG reviewed and tested four of the six petty cash accounts and determined that replenishment for the petty cash account at the Mankato office was not supported with adequate documentation to show that the amount replenished matched the amount used. The amount requested was $409.01; however, the amounts shown on the supporting documentation totaled only $63.67.

The SMRLS Accounting Manual states that offices requesting petty cash funds must provide an approved check request form along with an explanation of each disbursement and supporting receipts.

Management stated they were unaware that supporting documentation was not provided with the replenishment request. Without management review and adequate supporting documentation showing how much was disbursed from the fund, petty cash could be subject to misuse and abuse.

Recommendations: The Executive Director should:

Recommendation 9: enforce the policies and procedures detailed in the SMRLS Accounting Manual by ensuring that bank reconciliations are performed monthly, documented with a signature and date, and properly approved by a responsible person.

Recommendation 10: review and resolve checks outstanding over six months and adopt a written policy to that effect.

Recommendation 11: enforce SMRLS's Accounts Payable & Cash Disbursement policy by ensuring that supporting documentation is received and reviewed prior to replenishing the petty cash, regardless of amounts.

DISBURSEMENTS

The OIG randomly selected and tested internal controls for 82 disbursements consisting of 98 transactions amounting to a total of $408,757.39. Although all of the transactions were traced to the grantee's general ledger and those allocated to LSC funds were allowable per LSC's *Fundamental Criteria*, the OIG identified the following:

- Seven disbursement transactions totaling $2,953.21 did not contain supporting packing slips or any other evidence of receipt of goods; and
- Five disbursement transactions totaling $12,692.86 had missing requisite approvals.

Section 3-5.4, Cash Disbursements of the LSC's *Fundamental Criteria Accounting Guide* requires that approvals from appropriate levels of management are required before resources are committed and that the receipt of goods and accuracy of invoices should be verified and documented. Also, an organized method should be established to accumulate and file all documents relating to a particular disbursement for future reference.

Our testing revealed weaknesses in the following two areas that need to be addressed by the grantee.

<u>Lack of evidence of receipt of goods</u>

The Controller stated that the individual receiving goods is not required to retain the packing slip included with the deliveries because an invoice is usually received shortly after the delivery; therefore, no packing slips were retained.

Without adequate internal verification of the packing slips and invoices, cash may be disbursed for goods and services: 1) not received; 2) in advance of receipt of deliverables; or 3) in the wrong amount.

<u>Preapproval of disbursements</u>

The Controller of SMRLS stated that a verbal approval is obtained at an appropriate level of management before purchases are made. However, approvals granted are not documented. The CEO stated that she occasionally submits expense reimbursements receipts and agreed that appropriate approvals must be obtained from the Board of Directors.

Failure to obtain appropriate approvals may result in unauthorized transactions, abuse and waste of financial resources.

<u>Recommendations:</u> The Executive Director should:

<u>Recommendation 12:</u> develop and implement policies and procedures requiring preapproval of purchases before related expenditures are incurred.

<u>Recommendation 13</u>: develop a written policy to ensure that evidence of receipt, such as packing slips, is maintained for purchases of all goods.

LACK OF APPROPRIATE APPROVALS ON THE EXECUTIVE DIRECTOR'S REIMBURSEMENTS

The OIG's review of the Executive Director's reimbursements found that they were not approved by a Board member. The OIG found three travel reimbursements requested by the Executive Director in the amount of $1,663.86 that were approved by the Chief Operating Officer during our audit period.

The Executive Director stated she only occasionally submits her reimbursements to the Board for approval, but not always. Currently, there is no policy on approval of the Executive Director's reimbursable expenses.

Without approval from an appropriate level of management for reimbursements, there is a potential risk of waste and abuse of the grantee's financial resources.

Recommendation 14: The Executive Director should develop and implement a policy requiring her expense reimbursements to be reviewed and approved by a member of the Board of Directors.

SUMMARY OF GRANTEE MANAGEMENT COMMENTS

The grantee fully agreed with 11 out of 14 recommendations and associated findings, and partially agreed with 2 of the recommendations contained in the report. One remaining finding, related to untimely monthly reports, is a result of incorrect information being provided to the OIG from the grantee. The findings and recommendations address derivative income, update of the Grantee's Accounting Manual, documentation of the contracting process and procedures, cost allocation, fixed assets, internal budgeting and reporting, internal controls over disbursements and approval processes for the executive director's transactions.

Grantee management partially agreed with our recommendation and associated finding on cost allocation. They disagreed with the OIG with respect to their methodology needing to be modified; however, they did agree that the methodology needs to be documented and they will take steps to ensure it is in writing.

Grantee management partially agreed with our findings and recommendations in the area of property. They felt that not all of their property, specifically electronic devices, which are not capitalized, need to be inventoried. The SMRLS property policy requires "all" property to be inventoried. However, they consider "all" property to mean "capitalized" property, not electronic devices under the $5,000 capitalization threshold. They did agree however, to update their property listing during the next inventory in 2016; and they will update the locations of laptops and other electronic devices at this time.

SMRLS management stated that the OIG's finding on untimely monthly reports was in response to incorrect information provided by SMRLS staff during OIG interview. The Executive Director has access to all financial reports on a real-time basis through the accounting system. They stated that they are finding a better way to document the review of monthly reports.

OIG EVALUATION OF GRANTEE MANAGEMENT COMMENTS

The OIG considers the grantees planned actions responsive to all 14 of the recommendations. Recommendations 10 and 14 are considered closed.

Recommendations 1, 2, 5, 9, 12 and 13 in the report are considered responsive and will remain open until SMRLS's Board of Directors approves the revised policies and the OIG receives written notification that the policies have been approved and implemented. With respect to Derivative income, the OIG will still question $18,250 in SSI reimbursements and $2,998 in rental income. These amounts will be referred to LSC management for further action and review.

Recommendations 3, 4, 6, 7, 8 and 11 will remain open until the OIG is notified that the processes and methods proposed by the grantee are implemented.

With respect to the OIG's finding on cost allocation, the grantee expressed that they believe their methodology was reasonable and in accordance with federal regulations. The OIG's test work revealed that the grantee's current methodology yielded fair and reasonable allocations to the various funding sources. Although the process is not systematic and allocations are subject to restrictions limiting indirect charges to other grants, the grantee's explanation of maintaining the current system is reasonable as long as the methodology is adequately and clearly documented.

The grantee felt that their electronic equipment and computer equipment was not required to be inventoried based on their own internal property policy. Based on the $5,000 threshold for capitalizing equipment, the grantee has not inventoried sensitive electronic equipment. However, the grantee suggested that they will review their listing of laptops that contain sensitive information and update documentation of the location of these items. The OIG accepts the grantee's alternative solution.

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 requested the grantee's written cost allocation policies and procedures for review as required by the LSC Accounting Guide.

We performed detailed cost allocation testing for four employees' salaries to determine appropriate allocations to LSC funds. We also tested the cost allocation amounts for other indirect costs by reviewing such costs over two quarters using the information provided by the grantee.

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 98 transactions from 70 vendors. We reviewed supporting documentation, approvals and the appropriateness of each disbursement.

The on-site fieldwork was conducted from June 22 to June 30, 2015. Our work was conducted at the grantee's office in St. Paul, MN and at LSC headquarters in Washington, DC. We reviewed documents pertaining primarily to the period January 1, 2014 through May 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.

APPENDIX II

SMRLS
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ST. PAUL CENTRAL OFFICE*
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(651) 222-5863

EASTSIDE & AMERICAN INDIAN OFFICE
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St. Paul, MN 55130
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EAST METRO SUBURBAN OFFICE
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Shakopee, MN 55379
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REFUGEE, IMMIGRANT, and FARMWORKER SERVICES

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October 27, 2015

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

Dear Mr. Seeba:

Please find enclosed the comments to the Draft Report on the on-site OIG Selected Internal Controls that was conducted at SMRLS at the end of June 2015.

We thank you for taking the time to visit SMRLS and to offer suggestions and recommendations for SMRLS overall financial administration.

If you have any questions, please do not hesitate to contact me.

Sincerely,

Jessie R. Nicholson

Jessie R. Nicholson, Esq.
Chief Executive Officer

**SOUTHERN MINNESOTA REGIONAL LEGAL SERVICES, INC.
RESPONSE TO DRAFT REPORT ON SELECTED INTERNAL CONTROLS
LEGAL SERVICES CORPORATION – OFFICE OF INSPECTOR GENERAL
OCTOBER 2015**

SMRLS administrative team appreciates the work of the OIG Audit team during their visit in June, 2015. The OIG team was helpful and respectful in pointing out areas where SMRLS could improve its financial management.

As SMRLS advised OIG before the OIG team's arrival, the review occurred during a time of tremendous transition in its financial operations because of the recent arrival of a new Controller (July, 2014), beginning of the implementation of a new accounting system (August, 2014), the change in SMRLS' fiscal year to a calendar year (December, 2014) which resulted in a "stub year" of 9 months ending on December 31, 2014, and the recent completion of the annual financial audit (issued April 20, 2015). In order to incorporate the results of all of these recent changes into its Accounting Manual, SMRLS delayed the planned update of the Accounting Manual until after the new staff and systems had been fully implemented. The OIG team's recommendations will be very helpful in ensuring that the revised SMRLS Accounting Manual follows LSC's *Accounting Guide for LSC Recipients* (2010 Edition). The disruption caused by the change in fiscal year end is evidenced by the OIG team's report which uses the annual amounts of the LSC grant and compares it to the 9 month total revenue number in the December 31, 2014 Audit report, to arrive at the percentage of revenue attributable to LSC funding.

Derivative Income

SMRLS agrees with the OIG team's identification of $18,250 of Minnesota SSI reimbursements and $2,998 of rental income from a sublease as being funds that should be allocated to the LSC grant. SMRLS has always been aware of the need to track Derivative Income that is directly tied to LSC funds, such as interest earned while LSC funds are held by SMRLS. Due to the very short period of time that the LSC funds are held by SMRLS before they are expended and the historically low interest rates earned on those funds, this income has been very low for quite some time. The OIG team pointed out to SMRLS that the regulation governing derivative income is much broader than just this type of direct income and would include any reimbursement funds (i.e. attorneys' fees, reimbursement grants and sublease rents) received as the result of any activity funded by LSC.

SMRLS has sufficient funds on hand to follow LSC's direction, once LSC management has determined the proper action to be taken on this issue.

Recommendation 1

SMRLS immediately adjusted its systems in order to ensure that any revenues, of whatever kind, that are received as the result of any activity funded by LSC are allocated to the LSC grant. A new policy has been drafted and will be incorporated into the revised SMRLS Accounting Manual.

Accounting Manual

As explained above, and acknowledged by the OIG team, SMRLS made a conscious decision to delay the planned updates to its Accounting Manual due to the tremendous changes taking place in its financial operations and its desire to capture those changes in its new version. As the changes have now been more fully implemented, SMRLS has embarked on a complete revision of its Accounting Manual and will incorporate the changes recommended by the OIG team in the new Manual.

Recommendation 2

SMRLS Chief Executive Officer and Controller, working in conjunction with the SMRLS' Board of Directors' Finance and Audit Committee, is undertaking a complete revision of its Accounting Manual, to be completed in 2016.

Contracting

SMRLS' Procurement Policy was adopted by its Board of Directors in June, 2008. The policy sets thresholds for the level of process needed for varying expenditure levels as required by LSC's *Accounting Guide for LSC Recipients* (2010 Edition) Fundamental Criteria 3-5.16. The phone and broadband service contract was competitively bid in 2006, but the documentation of the competitive bids in response to the RFP process were not retained in the central contract files and could not be produced during the OIG team's fieldwork.

Recommendation 3

SMRLS is undergoing a review of all of its contract files to ensure that all quotations, bids and approval documentation are maintained with the accepted contract in every instance. As new contracts are approved, the required documentation is being retained in the contract file.

Recommendation 4

SMRLS is undergoing a review of all of its contract files to ensure that they have current, signed contracts that appropriately document the scope of work to be performed.

Cost Allocation

As discussed with the OIG team, not all grants include funds for indirect costs, so it is not feasible to allocate indirect costs on a direct proportionate basis for all funding sources. A very high percentage (>90%) of the work at SMRLS is for LSC-eligible clients, even though LSC's share of SMRLS' total revenue is less than 20%. The Minnesota legislative appropriation for SMRLS and the LSC Basic Field grant are the revenue sources that allow for the most flexibility in allocating indirect costs and it has been SMRLS' practice to rely on those sources on a slightly more than proportional basis to pay those indirect costs. As noted by the OIG team, the resulting amount funded by LSC "does not appear to be excessive and is in accordance with 45 CFR §1630.3 (e)." 45 CFR §1630.3 (g) also provides that "Some funding sources may refuse to allow the allocation of certain indirect costs to an award. In such instances, a recipient may allocate a proportional share of another funding source's share of an indirect cost to Corporation funds, provided that the activity associated with the indirect cost is permissible under the LSC Act and regulations." Because it appears to meet the requirements of federal regulations, SMRLS will continue its current methodology to allocate indirect costs.

Recommendation 5

As part of the revision of SMRLS Accounting Manual, SMRLS will document its cost allocation methodology in accordance with the guidance provided by the OIG team and the federal regulations.

Property

Physical Inventory

SMRLS conducted an inventory of its property listed on its Fixed Asset listing in the winter of 2014 as noted in the OIG team's report.

Recommendation 6

SMRLS will conduct a full inventory of items on its listing of Fixed Assets in mid-2016 and update its Fixed Asset listing as needed.

Fixed Assets

LSC's *Accounting Guide for LSC Recipients* (2010 Edition) in Appendix VII, Section C(1), recommends a threshold of $5,000 for capitalizing fixed asset purchases. This is the threshold of capitalization that has been adopted by the SMRLS Board of Directors. The electronic devices selected for testing by the OIG team do not meet this threshold level and are not listed on SMRLS' Fixed Asset list. LSC's *Accounting Guide for LSC Recipients* (2010 Edition) provides that a recipient "should be mindful of items that may contain sensitive information…with values lower than $5,000." There is no indication that SMRLS is not appropriately safeguarding that equipment. All of SMRLS' laptops have locked hard drives that require a password in order to even boot the machine.

While the SMRLS Accounting Manual's Property and Equipment Inventory policy requires an inventory of "all" property and equipment, the policy has always been applied only to "capitalized" property and equipment. The revised Accounting Manual will make this distinction clear.

Recommendation 7

SMRLS will update its listing of Fixed Assets following the full inventory conducted in 2016 and include any applicable missing fields. SMRLS will review its listing of laptops that may contain sensitive information and update documentation of the location of these items.

Internal Reporting and Budgeting

Untimely Monthly Reports

The OIG finding on this issue was in response to incorrect information provided by SMRLS staff during the OIG review. The correct response is that financial information is available to the Chief Executive Officer on a real-time basis through the NetSuite dashboard. SMRLS' CEO can review all financial reports, including budgeted versus actual income and expense information, cash on hand, aged accounts receivable and aged accounts payable. Any variances or unexpected results are discussed with the Controller. Because SMRLS' Controller is still relatively new to her position, she understood the OIG team's questions regarding monthly management reports to be the same as financial statements and indicated that it was difficult to close a month in less than a month because invoices and expense reports for the period continue to come in for up to 30 days after the end of a month. The Controller was referring to the quarterly financial statements that the Controller prepares for the Board of Directors and the Board's Finance and Audit Committee. SMRLS has reviewed the information in the LSC *Accounting Guide for LSC Recipients* (2010 Edition) which describes the monthly management report contents in more detail.

During the time of the audit, we were involved in the implementation of a new accounting system. The written policies and procedures for internal reporting will be updated as part of the wrap up of the implementation. All references to reports from the prior accounting system will be removed and only reference to reports used in the new system will be included.

The written policies and procedures for budgeting are out of date due to the change in the organization's fiscal year and the need to fit the new dates into the Board of Director's calendar of meetings. We have had current discussions on the appropriate timing of the Budget activities and will be preparing documentation to support the new process soon.

Recommendation 8

SMRLS is developing a better method for documenting this review, including using a pre-determined time for the review, documentation of any comments to explain variances and documentation of the review itself. These will be included in the revised SMRLS Accounting Manual.

General Ledger and Financial Controls

Bank reconciliations and outstanding checks

SMRLS reconciles its Operating, Repurchase and Client Trust accounts monthly. Given the lack of activity and relative low risk due to limited access to the accounts, or limited funds held in the accounts, SMRLS' Certificate of Deposit and Petty Cash accounts are reconciled quarterly. These changes will be reflected in the revised SMRLS Accounting Manual.

Our Operating and Repurchase bank accounts are reconciled by an accountant currently filling the AP bookkeeper position. The bank reconciliation effort always begins as soon as the bank statement is available. Due to the implementation of the new accounting system, the finalization of the bank reconciliations has been taking longer than documented in the Accounting Manual.

Petty Cash

Only the SMRLS' St. Paul Central office maintains a true "petty cash" fund. The accounts at other SMRLS offices are small balance checking accounts that are replenished when the funds are depleted. The bank statements are reviewed monthly, but due to the low volume and small dollar amounts held in the accounts, SMRLS has formally reconciled the accounts only on a quarterly basis. SMRLS has determined that the risk of loss on these accounts is very low. Because the accounts are managed in the individual offices and the funds are provided by SMRLS Finance Department, the segregation of duties on these accounts is actually higher than with SMRLS' general Operating account.

SMRLS has been in the process of revising the frequency and process used in preparing petty cash reconciliations. The reconciliations were in process and not complete when reviewed by OIG; some requested changes had not yet been completed and the reconciliation had not been approved.

Recommendation 9

SMRLS will update its Accounting Manual to accurately reflect its determination regarding the accounts to be reconciled monthly and those that can be reconciled quarterly. SMRLS will ensure that it properly undertakes and documents the reconciliations provided for in its Accounting Manual.

Recommendation 10

In response to the OIG recommendation 10, SMRLS has tightened its review process for outstanding checks to require a written report documenting the steps being taken to resolve any checks outstanding for more than 90 days.

Recommendation 11

SMRLS will revise its process to obtain and review supporting documentation before Petty Cash accounts are replenished. Any discrepancies must be reviewed and approved by SMRLS' Chief Operating Officer. The revised SMRLS Accounting Manual will document the process for documenting Petty Cash expenditures.

Disbursements

During the implementation of the new accounting system, additional control procedures have been performed. The Controller currently reviews each accounts payable invoice and performs the approval process in NetSuite. This is facilitated by preparation of an AP invoice batch by the AP processor. This batch sheet acts as a cover sheet for all of the invoices and check requests and the related support. The Controller reviews the account coding as well as the grant identifier. If the invoice is marked as "Pending Approval" in NetSuite, a payment cannot be generated. Periodically, generally weekly, payment runs are generated. A cover sheet is prepared which lists each payment proposed to be made. The Controller reviews the cover sheet and each invoice for which a payment is to be made.

Standard procedures have always required that checks be issued by the Controller; both the Controller and the AP processor sign off after reviewing the beginning check number and ending check number pre-printed on the check forms. The AP processor then takes possession of the blank checks and prepares the check run. Printed check are attached to the relevant invoice or support before the checks are presented to the check signers.

All checks require two signatures. There are five check signers; the CEO, COO, two Leadership Attorneys and the Central office Support staff Supervisor. None of the check signers have access that would allow any of them to record or approve transactions in the accounting system.

SMRLS does not currently have a policy requiring a three-way match (Purchase Order, Receiving report and Invoice) prior to payment of an Accounts Payable Invoice. Prior to the audit, management had begun discussing the need to add a level of formality and documentation to its informal Purchase Order process. During the audit, the OIG auditors suggested implementing the use of packing slips to support the receipt of office supplies and also encouraged the further development of a Purchase Order process.

Since the audit, we have begun to use the packing slips to evidence receipt of office supplies in some locations. We will be formalizing the process by providing training and written instructions to improve the consistency of application of the new process.

Recommendation 12

SMRLS will develop a policy and procedure as part of its revised Accounting Manual to set appropriate approval thresholds and authority for SMRLS leadership and document that approval as part of the purchasing process.

Recommendation 13

SMRLS is implementing a process that will require evidence of receipt of goods before payment for the goods is approved. The process will be included in the revised SMRLS Accounting Manual.

Lack of Appropriate Approvals on the Executive Director's Reimbursements

Recommendation 14

The SMRLS Board adopted a policy in September 2015 that requires SMRLS Chief Executive Officer's expense reports to be reviewed and approved by a SMRLS Board Officer before they can be processed for payment.