

Audit Report

Maryland Legal Services Corporation

July 2009



OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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Karl S. Aro
Executive Director

DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

Bruce A. Myers, CPA
Legislative Auditor

July 30, 2009

Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the Maryland Legal Services Corporation (MLSC) for the period beginning February 13, 2006 and ending March 15, 2009. In accordance with State law, MLSC receives funding from the Maryland Legal Services Corporation Fund, which is administered by the Administrative Office of the Courts (AOC). The funds received are distributed to grantees that provide legal assistance to eligible clients in civil proceedings or matters.

Our audit disclosed that MLSC had not entered into a formal understanding with the AOC as to the disposition of unspent funds. MLSC's investment of unspent funds totaling \$2.8 million resulted in a loss. MLSC also had not established sufficient policies and procedures to ensure that grant funds were being used in accordance with the related grant agreements. Lastly, adequate internal controls were not in place over the bank account used to collect interest on lawyer trust accounts.

MLSC's response to this audit is included as an appendix to this report. We wish to acknowledge the cooperation extended to us during the course of this audit by MLSC.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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Background Information

Agency Responsibilities

The Maryland Legal Services Corporation (MLSC) is a nonstock, nonprofit corporation that distributes funds to grantees (nonprofit organizations) that provide certain legal assistance to income-eligible clients who are unable to pay for private counsel. MLSC is governed by a nine-member Board of Directors appointed by the Governor with the advice and consent of the Maryland Senate.

In accordance with the Annotated Code of Maryland, MLSC receives the vast majority of its funding from the Maryland Legal Services Corporation Fund (Fund), which is administered by the Administrative Office of the Courts (AOC). The Fund primarily includes interest on lawyer trust accounts (referred to as IOLTA) and certain surcharges assessed in civil court cases as provided for in State law. In addition, State law provides for the Governor to appropriate \$500,000 each year to the Fund, which has historically come from abandoned property funds deposited in the State's General Fund. Throughout each fiscal year, the AOC issues equal monthly disbursements from the Fund to MLSC based on projected Fund income. The table below depicts the amounts transferred by AOC from the Fund to MLSC during fiscal years 2006 through 2009 (along with the original revenue source).

Funds Transferred by AOC to MLSC

Revenue Source	Fiscal Year 2006	Fiscal Year 2007	Fiscal Year 2008	Fiscal Year 2009
IOLTA	\$ 4,258,320	\$ 6,384,061	\$ 6,723,236	\$ 3,950,869
Circuit Court Surcharges	1,973,855	2,120,750	2,285,382	2,525,772
District Court Surcharges	4,850,795	4,768,285	5,190,200	5,372,595
Abandoned Property Fund	500,000	500,000	500,000	500,000
Total	\$ 11,582,970	\$ 13,773,096	\$ 14,698,818	\$ 12,349,236

Source: AOC records

Financial Statements

In accordance with the Human Services Article, Section 11-407 of the Annotated Code of Maryland, MLSC engaged an independent accounting firm to audit its financial statements annually. In the related audit reports, the firm stated that the

financial statements presented fairly, in all material respects, the financial position of MLSC as of June 30, 2006, 2007, and 2008, and the changes in its net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Status of Findings From Preceding Audit Report

Our audit included a review to determine the status of the finding contained in our preceding audit report dated June 27, 2006. We determined that MLCS had satisfactorily resolved that finding.

Findings and Recommendations

Unexpended State Funds

Finding 1

The Maryland Legal Services Corporation (MLSC) did not obtain a formal understanding with the Administrative Office of the Courts (AOC) as to the disposition of unspent funds.

Analysis

MLSC did not formalize its understanding, with the Administrative Office of the Courts (AOC), as to the disposition of unspent funds. During fiscal years 2006 and 2007, MLSC transferred \$1.3 million and \$1.5 million, respectively, from its operating account and invested the funds in conjunction with other MLSC investments. The operating account is used for the Maryland Legal Services Fund (Fund) revenue received from the AOC and is intended to be disbursed as grant awards, such as to nonprofits, to be used to provide legal assistance to income-eligible clients. However, when MLSC determined that additional grant awards were unnecessary, rather than return the funds, it retained and invested them.

State law governing the Fund does not address the disposition of unspent funds. In response to our inquiries, MLSC management obtained an advice from the Office of the Attorney General, which concluded that MLSC may retain unspent funds, so long as the funds are ultimately used to provide civil legal services for the indigent. The advice further concluded that it would be advisable for the MLSC and the AOC to enter into a memorandum of understanding, or to otherwise document their understanding, as to the disposition of the unspent part of an annual appropriation.

The investment of these funds is significant because the market value of MLSC's investment portfolio significantly declined after the investment of these funds. As a result, unless the market values recover, these funds are no longer available to be disbursed as grant awards, as originally intended. Furthermore, State law states that MLSC shall use the Fund to provide funding for civil legal services to indigents. According to MLSC's records, the value of all of its investments declined from \$7.1 million¹ as of November 30, 2006 to \$5.4 million as of February 28, 2009 (a \$1.7 million loss). Approximately \$689,000 of this loss

¹The \$7.1 million in investments at November 2006 included approximately \$5 million in principal and interest related to funds that were accumulated prior to July 1, 1998. MLSC previously received an advice from the Office of the Attorney General that permitted the retention of any unexpended funds prior to the establishment of the Fund in July 1, 1998.

related to the aforementioned \$2.8 million in retained funds. Furthermore, had the funds been returned to the AOC, the State Treasurer would have invested the funds and credited the earnings to the Fund, which is a special non-lapsing fund. In this regard, the average interest rate for the State Treasurer investments during this period was 4.6 percent, which would have resulted in investment income of approximately \$302,000.

MLSC management personnel advised us that they want to maintain an investment balance that approximates 50 percent of MLSC's annual operating budget, which contributed to the decision to retain the funds. The investments serve as a reserve so that MLSC can continue to fund programs in the event of a decline in its revenue sources. MLSC has a policy which authorizes investments of its funds into fixed income and equity securities.

Recommendation 1

We recommend that MLSC

- a. notify the AOC of the status of the invested funds, and**
- b. formalize its understanding with the AOC, such as through a memorandum of understanding, as to the disposition of unspent funds.**

Grants

Finding 2

MLSC lacked sufficient policies and procedures to ensure that grant funds were being used in accordance with the related grant agreements, and did not take appropriate follow-up action when deficiencies were identified.

Analysis

MLSC lacked sufficient policies and procedures to ensure that grant funds were being used in accordance with the related grant agreements, and did not always take appropriate follow-up action when deficiencies were identified. MLSC requires grantees receiving \$50,000 or more to be audited annually by an independent certified accountant and grantees receiving less than \$50,000 to obtain a financial review. In addition, MLSC generally required grantees to obtain a statement of positive assurance as to the grantees compliance with MLSC grant provisions. In certain cases (for example, when it would place a financial hardship on the grantee), MLSC waived the grant compliance statement requirement and hired a contractor to conduct a review of the grantees to ensure they were operating in compliance with grant terms.

During fiscal year 2008, MLSC awarded grants to 38 legal services organizations totaling approximately \$13.6 million. Our test of grants to six of these organizations, which totaled approximately \$9.7 million, disclosed the following conditions:

- MLSC did not have procedures to verify the number of clients served, as reported in the grantees annual reports, to ensure that the grantees served the number of clients proposed in their grant applications. Specifically, the agreed-upon procedures did not include a verification of the number of reported clients being served. In this regard, one of the criteria used to evaluate grant applications is the ability of the grantee to maximize the number of potentially eligible clients who will benefit from the legal services. As a result, there was a lack of assurance that the grantees were serving the number of clients proposed in their grant applications.
- MLSC did not have a formal policy on the scope and format of the statement of positive assurance as to the grantees' compliance with MLSC grant provisions that was to be prepared by the grantees' independent accountants. As a result, certain statements did not provide sufficient detail as to what compliance attributes were tested by the independent accountants.
- MLSC did not always take adequate follow-up action when grantee noncompliance was identified. For two of the grantees tested, for whom MLSC had contracted for a review of grantee compliance, we noted that both had certain areas of non-compliance with grant terms (for example, the client appeared to exceed the income guidelines) and appropriate follow-up action was not taken. Specifically, for one of the reviews tested, MLSC did not require the grantee to submit a corrective action plan. For the other review, the grantee responded that the population subject to review included clients that were not served with grant funds and MLSC did not pursue this issue further (such as by testing additional clients that were reportedly served with grant funds).

Recommendation 2

We recommend that MLSC

- a. establish procedures to verify the number of clients served, as reported by the grantees;**
- b. ensure grant agreements specify, in sufficient detail, the scope and format of the grant compliance statement; and**
- c. take appropriate follow-up action, such as expanding testing and requiring a correction action plan, when grantee noncompliance is identified, including for the grantees noted above.**

Interest on Lawyer Trust Accounts (IOLTA)

Finding 3

MLSC had not established sufficient controls over its lock box bank account used to collect interest from lawyer trust accounts.

Analysis

MLSC had not established sufficient controls over its lock box bank account used to collect interest on lawyer trust accounts (IOLTA). Specifically, although MLSC prepared monthly bank reconciliations for the lock box account, the reconciliations were not reviewed and approved by independent supervisory personnel. Such reviews are critical since the employee who prepared the reconciliations also had authority to process wire transfers. Although we did not note any instances in which MLSC failed to ultimately forward the appropriate funds to the AOC, the aforementioned condition could result in unauthorized wire transfers going undetected. According to MLSC records, the lock box account was used to process approximately \$6.7 million in IOLTA income during fiscal year 2008.

State law provides that lawyers operating in the State shall deposit trust money received during the normal course of business in an interest bearing account. The law further provides that certain interest from the lawyer trust accounts (IOLTA),² less any bank fees, is to be used to provide funding for civil legal services to the indigent. Prior to the creation of the Fund in July 1998, the law provided that the financial institutions pay the IOLTA revenue to MLSC. Subsequent law provides that the IOLTA revenue is to be paid to the Fund, which is administered by AOC. Accordingly, MLSC transfers the lockbox receipts to the AOC for deposit into the Fund.

Recommendation 3

We recommend that MLSC ensure bank reconciliations for the lockbox account are reviewed and approved by supervisory personnel.

² For example, when the lawyer reasonably expects that, for the period that the lawyer expects to hold the trust money, the interest would not exceed \$50, the interest should be used to provide services to the indigent.

Audit Scope, Objectives, and Methodology

We have audited the Maryland Legal Services Corporation (MLSC) for the period beginning February 13, 2006 and ending March 15, 2009 as prescribed by the Human Services Article, Section 11-408 of the Annotated Code of Maryland. The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The objectives of this audit were to examine MLSC's financial transactions, records and internal control, and to evaluate its compliance with applicable State laws, rules, and regulations. We also determined the status of the finding contained in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of MLSC's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

MLSC's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including the safeguarding of assets, and compliance with applicable laws, rules and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes findings related to conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect MLSC's ability to maintain reliable financial records, operate effectively and efficiently, and comply with applicable laws, rules, and regulations. This report also includes conditions relating to significant instances of noncompliance with applicable laws, rules, or regulations. Other less significant findings were communicated to MLSC that did not warrant inclusion in this report.

MLSC's response to our findings and recommendations is included as an appendix to this report. We will advise the MLSC regarding the results of our review of its response.



Board of Directors

July 28, 2009

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Bruce A. Myers, CPA
Legislative Auditor
Department of Legislative Services
Office of Legislative Audits
Maryland General Assembly
301 West Preston Street, Room 1202
Baltimore, MD 21201

Dear Mr. Myers:

I am in receipt of your draft audit report dated July 16, 2009 on the Maryland Legal Services Corporation for the period beginning February 13, 2006 and ending March 15, 2009.

The audit contained three findings, the first regarding the need for an agreement with the Administrative Office of the Courts regarding unspent funds; the second regarding grant audit/review procedures, and the third involved controls over an MLSC bank account. MLSC appreciates the opportunity to respond to these findings, comments and related recommendations, and will address each one, in turn, below.

Finding 1: “MLSC did not obtain a formal understanding with the Administrative Office of the Courts (AOC) as to the disposition of unspent funds.”

Response: This finding relates to funds held pursuant to MLSC’s reserve policy that was adopted by the MLSC Board of Directors in 1991 which calls for a reserve fund “equal to at least 50% of the total annual projected grants, operating budget and special commitments for the next fiscal year.” This policy was adopted upon a recognition that the Interest On Lawyer Trust Accounts (IOLTA) Program, as MLSC’s primary source of revenue, proved to be a very unpredictable funding source. (IOLTA revenue consists exclusively of interest income and fluctuates based on balances held in attorney trust accounts and short-term interest rates.) As such, the Board determined that it was essential for MLSC to maintain an adequate reserve in order to assure the Corporation’s ability to complete grant commitments and best ensure the stability of Maryland’s civil legal services delivery system in the face of a highly volatile funding source. MLSC’s continued experience with the volatility of IOLTA income has repeatedly demonstrated the wisdom of this policy and the value of a reasonable reserve fund as a sound practice for its financial operations.

Bruce A. Myers
July 28, 2009
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The AOC is aware of MLSC's Reserve Policy and the status of invested funds, as well as MLSC's transfer of unspent funds into the Reserve Fund to help maintain the Fund's target level. Indeed, MLSC regularly sends copies of minutes from its Board of Directors' meetings along with all related meeting materials to the AOC. MLSC acknowledges, however, that it did not have a formal understanding with the AOC as stated in this finding. MLSC has since been in contact with the AOC regarding this issue, and MLSC and the AOC will enter into a memorandum of understanding, or otherwise document MLSC's and AOC's understanding as to the disposition of unspent funds and MLSC Reserve Fund policy and practices, as advised by the Office of the Attorney General and recommended in your report.

MLSC strongly disagrees with the discussion contained under Finding 1 regarding MLSC's investments, and takes issue with the portrayal of funds as "no longer available to be disbursed" as well as the portrayal of the amount of "paper losses" in connection with MLSC's investment of such funds.¹ Exercising its fiduciary duties and judgment, the MLSC Board established and adheres to a prudent and conservative blended market index investment policy for its "Grant Stabilization/ Reserve Fund." (See Fund parameters, attached).² It should be noted that this investment approach was adopted in 2005 to avoid paying thousands of dollars annually in fees to have a managed fund, which research has shown rarely performs above index benchmarks.

The analysis contained in your report presents a snapshot of the Fund at a time that coincides with the biggest downturn in financial markets in our nation's history since the Great Depression. As such, this snapshot of "paper losses" presents an unreasonable and meritless representation of the overall performance of the Fund. Indeed, taking a "snapshot" of the Fund as of close of business yesterday, July 27, 2009, the Fund's value of \$5,609,383 is 4.3 percent higher than the net amount of actual dollars, totaling \$5,375,917, deposited into the Fund since its inception in 2005. It should be noted that due to plummeting IOLTA revenue, MLSC will be spending significantly from this Fund in FY 2010 to help maintain the ability of its grantees to meet the dramatically increasing need of Marylanders requiring civil legal assistance as the effects of the economic crisis continue to unfold.³

¹ **Auditor's Comment:** The audit report has been revised to address MLSC's concern.

² **Auditor's Comment:** The MLSC investment policy has been excluded from the response to this report.

³ **Auditor's Comment:** Our finding reflects the status of the funds as of the time of our audit. While upturns in the market may result in changes to the losses, the impact still warrants a formalized understanding as recommended in the finding.

Bruce A. Myers

July 28, 2009

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Finding 2: “MLSC lacked sufficient policies and procedures to ensure that grant funds were being used in accordance with the related grant agreements, and did not take appropriate follow-up action when deficiencies were identified.”

Response: MLSC has developed and consistently implements a variety of policies and procedures for ensuring that grant funds are being used appropriately. MLSC requires statistical and financial reporting of grant activity twice each year and conducts desk reviews and on-site evaluations to review program activities, operations, and intended future activities. Based on reports and other ongoing communication with grantees, when deficiencies are discovered, follow-up calls and/or visits to grantees are made where necessary and appropriate. MLSC also requires annual financial audits of all grantees receiving grants of \$50,000 or more and annual financial reviews for those receiving less than \$50,000.

In addition to the above, grantees are required to submit statements of positive assurance with MLSC grant conditions, or if it is cost-prohibitive for a grantee to obtain the statement from its auditor, MLSC performs the programmatic audit of the cases served with MLSC funds using parameters approved in 1989 by the state legislative auditor. The majority of grantees have an independent audit firm provide the positive assurance statement with their annual financial audit. MLSC carefully reviews all audit reports, management letters, etc. and accepts the findings of the independent auditors.

The above finding and subsequent examples relate primarily to the programmatic audits conducted by MLSC. Since these are done in-house (MLSC hires a contractor to conduct these audits), MLSC has all of the work papers with details on every case reviewed, and we correspond with each audited grantee to report our findings to them, citing *any* findings even if they are not deemed to be material. To the extent there are material findings, MLSC requires the grantee to address these issues and describe how such shortcomings will be remedied going forward.

MLSC acknowledges, however, that its procedures for conducting programmatic audits and follow-up practices could be improved. MLSC will take a more systematic approach to its audit procedures and develop clear guidelines and practices for follow-up, as recommended. MLSC will also implement the recommendations to develop procedures to verify the number of reported clients being served, and to better specify the scope and format of the grant compliance statement provided as a model to its grantees. MLSC further notes that it appreciates the willingness of the legislative auditor to review these procedures and provide further guidance.

Bruce A. Myers
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Finding 3: “MLSC had not established sufficient controls over its lock box bank account used to collect interest from lawyer trust accounts.”

Response: MLSC acknowledges that sufficient controls were not in place with regard to its Lock Box account. Upon learning of this finding, MLSC immediately put in place the same satisfactory internal controls on this account that exist with regard to all other MLSC accounts.

We appreciate the thorough review provided to MLSC by your office, and thank you for bringing these issues to our attention. If you have any other questions or comments please do not hesitate to contact us.

Sincerely,



Susan M. Erlichman
Executive Director

Cc: Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
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