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**LEGAL SERVICES
CORPORATION**

**Improvements Needed in
Governance, Accountability,
and Grants Management
and Oversight**

Statement of Jeanette Franzel, Director
Financial Management and Assurance



Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our recent reviews¹ of Legal Services Corporation's (LSC) governance, accountability and grants management practices. LSC's mission is to make federal funding available to provide legal assistance in civil matters to low-income people throughout the United States on everyday legal problems. LSC pursues this mission by providing financial assistance, mostly through grants to legal service providers (grant recipients or grantees) who serve low-income members of the community who would otherwise not be able to afford legal assistance (clients). Established by a federal charter in 1974 as a federally funded, private nonprofit corporation,² LSC is highly dependent on federal appropriations for its operations. LSC received \$348.6 million in appropriations for fiscal year 2007, which made up about 99 percent of its total funding. In 2007, LSC served clients through 137 grantees with more than 900 offices serving all 50 states, the District of Columbia, and current and former U.S. territories.

LSC uses the majority of its funding to provide grants to local legal-service providers. Funds are distributed based on the number of low-income persons living within a service area,³ with some grantees maintaining several offices within their service area. LSC management is responsible for ensuring that grant funds are used for their intended purposes and in accordance with laws and regulations. Thus, LSC is accountable for the effectiveness of its own internal controls and for providing oversight and monitoring of grantees' internal controls, use of grant funds, and compliance with laws and regulations. LSC's Board of Directors is responsible for carrying out fiduciary responsibilities in overseeing LSC management's operations and use of appropriated funds.

In recent years, governance and accountability processes have received increased scrutiny and emphasis in the nonprofit, federal agency, and

¹ GAO, *Legal Services Corporation: Governance and Accountability Practices Need to Be Modernized and Strengthened*, [GAO-07-993](#) (Washington, D.C.: Aug. 15, 2007) and GAO, *Legal Services Corporation: Improved Internal Controls Needed in Grants Management and Oversight*, [GAO-08-37](#) (Washington, D.C.: Dec. 28, 2007).

² Legal Services Corporation Act of 1974, Pub. L. No. 93-355, 88 Stat. 378 (July 25, 1974), *codified, as amended*, at 42 U.S.C. §§ 2996 – 2996I (LSC Act).

³ Under 45 C.F.R. § 1634.2(c), the service area is the geographic area defined by LSC to be served by grants or contracts to be awarded on the basis of a competitive bidding process.

public company sectors as a result of governance and accountability breakdowns, most notably in the public company financial scandals that led to the enactment of the Sarbanes-Oxley Act of 2002. Public companies now operate under strengthened governance and accountability standards, including requirements for ethics policies and improved internal controls. The federal government and nonprofit sectors have followed this lead and established new standards and requirements for improved internal control reporting and governance and accountability. For nonprofit corporations using funding from taxpayers and donors, effective governance, accountability, and internal control are key to maintaining trust and credibility. Governance and accountability breakdowns result in a lack of trust from donors, grantors, and appropriators, which could ultimately put funding and the organization's credibility at risk.

The current period of economic hardship for many workers and their families' highlights the importance of LSC's mission and the efficient and effective use of taxpayers' dollars to achieve that mission. Today I will highlight our key findings on LSC's governance and accountability practices, as well as the internal control improvements needed in LSC's grants management and oversight to increase assurance that federal funds are being properly spent and its operations are effectively carried out to meet its mission of providing legal assistance to low-income people.

Our conclusions are based on work performed for our August 2007 report on LSC's governance and accountability practices⁴ as well as our December 2007 report on LSC's grants management and oversight.⁵ We conducted that work in accordance with Generally Accepted Government Auditing Standards. More detailed information on our audit scope and methodologies can be found in these two reports.

Summary

Although LSC has stronger federal accountability requirements than many nonprofit corporations, it is subject to governance and accountability requirements that are weaker than those of independent federal agencies and U.S. government corporations. Congress issued LSC's federal charter over 30 years ago. We found that LSC has not kept up with evolving reforms aimed at strengthening internal control over an organization's financial reporting process and systems. As noted in our reports, a

⁴ [GAO-07-993](#).

⁵ [GAO-08-37](#).

properly implemented governance and accountability structure may have prevented recent incidents of compensation rates in excess of statutory caps, questionable expenditures, and potential conflicts of interest. In addition, LSC has not kept up with current management practices. Of particular importance are key processes in risk assessment, internal control, and financial reporting. Also at the time of our review management had not formally assessed the risks to the safeguarding of its assets and maintaining the effectiveness and efficiency of its operations, nor had it implemented internal controls or other risk-mitigation policies.

We also found weaknesses in LSC's internal controls over grants management and oversight of grantees that negatively affect LSC's ability to provide assurance that grant funds are being used for their intended purposes in compliance with applicable laws and regulations. Effective internal controls over grants and grantee oversight are critical to LSC as its very mission and operations rely extensively on grantees to provide legal services to people who otherwise could not afford to pay for adequate legal counsel. We also found poor fiscal practices and improper and potentially improper expenditures by grantees.

As a result of our two reviews, we made a total of 9 recommendations to LSC's Board of Directors and 8 recommendations to LSC management. Those recommendations dealt with fundamental management and governance practices needed in the current environment in light of LSC's mission. Both LSC's Board and management accepted our recommendations and expressed a commitment to move diligently to implement the recommendations. LSC's most recent progress report indicates that LSC is starting to take action to address many of our recommendations and is planning to take action on the remaining recommendations with responsibility for corrective action already assigned. LSC has indicated that it will provide us with a final update by September 1, 2008 to document completion of its implementation of our recommendations. We look forward to receiving LSC's final report and reviewing the progress LSC Board and management have made on these issues.

LSC's Governance and Accountability Practices Need to be Modernized and Strengthened

We found that since its inception over 30 years ago, LSC's governance and accountability requirements, including its financial reporting and internal control, had not changed significantly. Further, LSC's board and management had not kept pace with evolving governance and accountability practices. As a result, LSC's current practices have fallen behind those of federal agencies, U.S. government corporations, and other nonprofit corporations.

For both governmental and nonprofit entities, governance can be described as the process of providing leadership, direction, and accountability in fulfilling the organization's mission, meeting objectives, and providing stewardship of public resources, while establishing clear lines of responsibility for results. Accountability represents the processes, mechanisms, and other means—including financial reporting and internal controls—by which an entity's management carries out its stewardship and responsibility for resources and performance. Strengthened governance and accountability structures within LSC will increase assurance that federal funds are spent properly and effectively in order to meet the needs of the clients receiving legal assistance.

Governance and Accountability Requirements

Because LSC is a unique federal entity, we compared its governance and accountability requirements to other federal entities. We found that although LSC has stronger federal accountability requirements than many nonprofit corporations, its governance and accountability requirements are weaker than those of independent federal agencies headed by boards or commissions and those of U.S. government corporations. The LSC Act provides that LSC be treated like a federal agency for purposes of specified statutes that existed in the 1970s. LSC's authorizing legislation was last comprehensively reviewed and reauthorized in the Legal Services Corporation Amendment Act of 1977, and LSC's governing statutes have undergone only limited changes since then.

In 1988, Congress created an Office of Inspector General (OIG) within LSC. Therefore, LSC is subject to IG oversight. However, in other respects, LSC has not kept up with evolving management reforms aimed at strengthening internal control over an organization's financial reporting process and systems. For example

- LSC's statutory requirements for internal control systems are less rigorous than those for independent federal agencies or U.S. government corporations. The LSC Act requires LSC to account for federal funds separately from nonfederal funds, but otherwise includes no specific

requirements for the establishment of accounting and internal control systems. Although the LSC Act includes program management requirements, these are much less rigorous than requirements for systems of internal control for other federal entities.⁶

- LSC is not subject to federal funds control laws that generally apply to independent federal agencies and many U.S. government corporations. Like many independent federal agencies and wholly owned government corporations, most of LSC's annual revenues come from federal funds made available through annual appropriations; however, LSC is not required by law to control its use of those funds as are independent federal agencies and wholly owned U.S. government corporations. Further, the accountable officers of most federal agencies and some wholly owned U.S. government corporations are financially liable for improper or illegal payments. However, this is not the case for LSC. The LSC Act does contain a number of provisions that restrict the use of LSC's appropriated funds for certain purposes, such as an activity that would influence the passage or defeat of any legislation at the local, state, or federal level or that would support any political party or campaign of any candidate for public office.
- Although the LSC Act requires LSC to submit a budget request to Congress, it provides no requirements related to the form and content of the budget request. For federal agencies and wholly owned U.S. government corporations, OMB prescribes the form and content of budget requests, consistent with specified statutory requirements that are submitted through the President to Congress. Under the LSC Act, LSC submits that budget request directly to Congress, with OMB's role limited to submitting comments to Congress if it chooses to review LSC's budget.

Governance Practices

During our review, we found that the governance practices of LSC's board fell short of the modern practices employed by boards of nonprofit corporations and public companies. Although the board members have demonstrated active involvement in LSC through their regular board meeting attendance and participation, we found several areas where LSC's governance practices could be strengthened. Those areas included a more comprehensive orientation program for new board members and an ongoing training program that enables board members to stay current on

⁶ The legislative requirements that promote effective internal control include Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. § 3512(c), (d)); Chief Financial Officers Act of 1990, as amended by the Government Management and Reform Act of 1994 and the Accountability of Tax Dollars Act of 2002 (31 U.S.C. § 3515); and Federal Financial Management Improvement Act of 1996 (Pub. L. No. 104-208, div. A., § 101(f), tit. VIII, 110 Stat. 3009, 3009-389 (Sept. 30, 1996) (*reprinted in* 31 U.S.C. § 3512 note)).

governance practices, the regulatory environment, and key management practices. Keeping current with governance practices is especially important for the LSC board because the board composition changes significantly with each new presidential administration, and thus the board does not generally have the benefit of experienced board members. Although the LSC board had four committees, including finance and operations and regulations, it did not have audit, ethics, or compensation committee, important governance mechanisms commonly used in corporate governance structures. Finally, the board has not assessed the performance, collectively or individually, of its board members.

Management Practices

LSC's management practices have not kept up with the current practices for key processes in the areas of risk assessment, internal control, and financial reporting. We found that management has not implemented a systematic or formal risk assessment that evaluates the risks the corporation faces from both external and internal sources. Such an assessment provides a structure for implementing internal control and other risk mitigation policies. Without an effective program of risk assessment and internal control, LSC management does not have adequate assurance that it is using organizational resources effectively and efficiently, nor reasonable assurances that LSC's assets and operations are protected. In addition, senior management has not established comprehensive policies or procedures regarding conflicts of interest or other issues of ethical conduct. Without such policies and procedures, LSC is at risk of not identifying potential conflicts of interest and not taking appropriate actions to avoid potentially improper transactions or actions on the part of LSC personnel. Such issues, if they occur, could result in loss of credibility to LSC as an organization. Also, management has not conducted its own assessment or analysis of accounting standards to determine the most appropriate standards for LSC to follow. Consequently, it is not clear which standards are most relevant to LSC's operations and which would provide the best financial information to LSC's management and financial statement users.

Improved Internal Controls Needed Over Grants Management and Oversight

In our review of grants management and oversight at LSC, we found weaknesses in LSC's controls over grants management and oversight that negatively affected LSC's ability to monitor and oversee grants and left grant funds vulnerable to misuse. At grantees we visited, we also found poor fiscal practices and improper or potentially improper expenditures that LSC could have identified with more effective oversight.

Internal control is an integral component of an organization's management that provides reasonable assurance that the objectives of effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations are being achieved.⁷ Internal controls also serve as the first line of defense in safeguarding assets and preventing and detecting errors and fraud. Organizations that award and receive grants need good internal control systems to ensure that funds are properly used and achieve intended results. Effective internal controls over grants and grantee oversight are critical to LSC as its very mission and operations rely extensively on grantees to provide legal services to people who otherwise could not afford to pay for adequate legal counsel. For LSC and other organizations that award grants, ensuring effective internal control over grant funds requires a two-prong approach. LSC management, in addition to being held responsible for its own internal control system, needs to provide oversight to help ensure that its grantees' internal control systems provide reasonable assurance that grant funds are properly used and achieve intended results.

We found weakness in LSC's control environment regarding the lack of a clear definition of the authority and responsibilities between two of the three organizational units that oversee the work of grantees. Currently, LSC management shares with the OIG fiscal oversight and monitoring of grantees. Management's oversight role is conducted through two offices — the Office of Program Performance (OPP) and the Office of Compliance and Enforcement (OCE). We found that the roles and the division of responsibilities were not clearly communicated between the OIG and OCE. The result has been staff confusion about the types and scope of grantee fiscal reviews that LSC management can undertake on its initiative and strained relations between management and the OIG. In addition, communication and coordination between OCE and OPP was not sufficient to prevent gaps and unnecessary duplication between the offices' respective oversight activities.

Regarding its oversight of grantees, we found that the scope of LSC's control activities for monitoring grantee fiscal compliance was limited, and feedback to grantees not timely. In determining the timing and scope of grantee oversight visits, LSC does not employ a structured or systematic approach for assessing the risk of noncompliance or financial control

⁷ GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (November 1999).

weaknesses across its 137 grantees. Without an analytically sound basis for assessing risk and distributing its oversight resources, LSC does not have a basis for knowing whether its oversight resources are being used effectively to mitigate and reduce risk among its grantees.

LSC's monitoring of grantee internal control systems needs to be strengthened. We found that the scope of work in OCE's fiscal reviews was not sufficient in assessing grantee internal control and compliance for purposes of achieving effective oversight. In the OCE site visits we observed, staff did not follow up on questionable transactions and relied heavily on information obtained through interviews. LSC also was not timely in follow up on an investigation into an alleged instance of noncompliance referred to it by the OIG. Feedback to grantees was often slow. As of September 2007, LSC had not yet issued reports to grantee management for almost 19 percent (10 out of 53) of the 2006 site visits. Without timely communications about the results of site visits, grantee management does not have information about deficiencies and the related corrective actions needed. In a grantee exit conference we observed, the LSC review team did not communicate a number of findings they had concluded were significant and in need of immediate attention. Effective grantee monitoring is especially important for LSC because LSC has limited options for sanctioning poorly performing grantees due to the recurring nature of many of its grants.

In the limited reviews we performed at 14 grantees, we identified internal control weaknesses at 9 grantees that LSC could have identified with more effective oversight reviews. We also found improper expenditures at some of the grantees we visited. While control deficiencies at the grantees were the immediate cause of the improper expenditures we found, weaknesses in LSC's controls over its oversight of grantees did not assure effective monitoring of grantee controls and compliance or prevent the improper expenditures. We identified the following weaknesses and improper expenditures at grantees we visited:

- Expenditures with insufficient supporting documentation – At 7 out of the 14 grantees we visited, we identified systemic issues involving payments that lacked sufficient supporting documentation that made it impossible to determine whether the expenditures were accurate, allowable, and appropriate.
- Questionable independent contractor – One grantee paid an individual approximately \$750,000 between 2004 and 2006 for information technology services. Several factors including the following caused us to question the contractor arrangement:

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- The contractor's office and mailing address were located in the same office space as the grantee.
 - The grantee could not locate its contract with the individual for 2005 and 2006.
 - The contractor's business card was identical to that of other employees working at the grantee.
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- Alcohol purchases – We identified three grantees that used LSC funds to purchase alcoholic beverages.
 - Employee interest-free loans - One grantee that we visited was using grant funds to provide interest-free loans to employees upon request as an employee benefit. The loans were used to pay college tuition, make down payments on homes, and to purchase computers.
 - Lobbying fees – We identified two instances in which one grantee was using LSC funds to pay lobbyist registration fees.
 - Late fees – Three of the grantees that we visited used grant funds to pay late fees on overdue accounts for goods and services purchased.
 - Earnest money – We discovered an improper transaction at one grantee involving the sale of a grantee building using both LSC and non-LSC funds. The grantee transferred the escrow account funds into an unrestricted general funds account to avoid the funds being subjected to LSC regulations.

Conclusions and GAO's prior recommendations

Effective governance and accountability practices are necessary to provide strong board oversight and effective day-to-day management of LCS's performance in carrying out its mission of promoting equal access to the system of justice in our nation and providing high-quality civil legal assistance to low-income persons. Effective internal controls over grants and grantee oversight are also critical to LSC, as its very mission and operations rely extensively on grantees to provide legal services to people who otherwise could not afford to pay for adequate legal counsel. Effective grants-oversight procedures and monitoring, including a structured, systematic approach based on risk, are necessary given LSC's limited resources and the scope of its responsibilities for many widely dispersed entities. In addition, the shared responsibilities for grantee oversight between LSC management and OIG presents risks that can be mitigated with clear lines of authority and responsibility and effective communications and coordination across oversight offices to avoid unnecessary duplication where possible. Finally, given the number of grantees, a sound risk-based approach for determining timing and scope of site visits is key to prioritizing resource allocations to reflect the varying risks presented by the grantees.

To maximize the effectiveness of each site visit, LSC needs to conduct its oversight visits with sufficient scope to target areas of greatest risk, follow up on information and results of prior reviews and audits, and employ a review scope and approach that is tailored to specific risks. With high-quality targeted reviews and management that promptly informs grantees about findings and provides them an opportunity to correct them, risk can be mitigated.

In our August 2007 report,⁸ we made recommendations to LSC's board for modernizing and strengthening its governance and oversight, including action directed at formalizing a comprehensive orientation program and an ongoing training program, conducting a performance assessment, creating audit and compensation committees, developing and implementing an approach to periodically evaluate certain key management processes, and ensuring that LSC's audited financial statements are issued more promptly. We also made recommendations to LSC management directed at improving its accountability by conducting a risk assessment and implementing a corresponding risk management program as part of a comprehensive evaluation of internal control, including establishing policies for handling conflicts of interest (ethics) and evaluating accounting standards.

In our December 2007 report,⁹ we made five recommendations to LSC to improve its internal control and oversight of grants by clarifying organizational roles and responsibilities for overseeing grantee internal controls and compliance among LSC units, improving information sharing and coordination among LSC oversight organizations, using risk-based criteria to select grantees for internal control and compliance reviews, improving the effectiveness of the current fiscal compliance reviews, and following up on each of the improper or potentially improper uses of grant funds that we identified.

In response to both of our reports, we received written comment letters from the Chairman on behalf of LSC's Board of Directors and the President on behalf of LSC's management. Both the Chairman and President expressed their commitment to achieving strong governance and accountability and outlined actions that LSC's board and management plan to take in response to the recommendations we made in our August 2007

⁸ [GAO-07-993](#).

⁹ [GAO-08-37](#).

report. The Chairman and the President also expressed their full commitment to making the improvements in controls over grants management and oversight noted in our December 2007 report, accepted all of our recommendations, and outlined the actions that LSC's board and management plan to take in response to our recommendations. LSC's most recent progress report on implementing our recommendations is highly encouraging. LSC has indicated that it is taking action to address many of our recommendations and is planning to take action on the remaining recommendations with responsibility already assigned. LSC has indicated that it will provide us with a final update by September 1, 2008 to document completion of its implementation of our recommendations. We look forward to receiving LSC's final report and reviewing the progress LSC Board and management have made on these issues.

In our August 2007 report, we also included a matter for congressional consideration concerning whether LSC should have additional legislatively mandated governance and accountability requirements modeled after what has worked successfully at federal agencies or U.S. government corporations. These requirements could be established either by amending LSC's current governing statutes or by converting LSC to a federal entity, such as a U.S. government corporation or an independent federal agency. LSC's Chairman and President commented on the matter that we presented for congressional consideration and provided their views that LSC's governing statutes are appropriate and have worked well and stated that many of the governance recommendations could be accomplished without changing the statutory framework of LSC.

Appendix I: GAO Contact and Staff Acknowledgments

GAO Contact

For further information about this testimony, please contact Jeanette M. Franzel, Director, Financial Management and Assurance at (202) 512-9471 or FranzelJ@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony.

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