Office of Inspector General
Legal Services Corporation

Inspector General
Jeffrey E. Schanz

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MEMORANDUM

TO:	Board of Directors Legal Services Corporation
FROM:	Jeffrey E. Schanz Inspector General
SUBJECT:	Transmittal of FY 2018 Financial Statement Audit Report
DATE:	May 23, 2019

The Office of Inspector General (OIG) contracted with the independent certified public accounting firm of Castro & Company, LLC (Castro) to audit the financial statements of the Legal Services Corporation (LSC) as of and for the fiscal years ended September 30, 2018, and 2017. The contract required that the audit be performed in accordance with auditing standards generally accepted in the United States of America, as well as the standards applicable to financial audits contained in the *Government Auditing Standards*, issued by the Comptroller General of the United States.

Castro's Independent Auditor's Report on the Financial Statements, Independent Auditor's Report on Internal Control, and Independent Auditor's Report on Compliance and Other Matters were dated May 6, 2019. The OIG received the final reports from the Independent Auditor on May 22, 2019.

In its Independent Auditor's Report on the Financial Statements, Castro reported that LSC's financial statements fairly presented, in all material respects, the financial position of LSC as of September 30, 2018, and 2017, and the related statement of activities and changes in net assets, cash flows, and functional expenses for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

Castro's Independent Auditor's Report on the Financial Statements and Independent Auditor's Report on Compliance with Laws and Other Matters reported that the results of their tests disclosed no instances of noncompliance or other matters required to be reported under *Government Auditing Standards.*

Castro's Independent Auditor's Report on Internal Control identified one deficiency in internal control that is considered to be a material weakness. Castro found that sufficient accounting resources and/or personnel with appropriate skill sets and quality control procedures are needed to promptly identify financial reporting and accounting discrepancies. This material weakness resulted in a prior year adjustment to the financial statements.

The OIG reviewed the audit reports from Castro and related audit documentation and inquired of their representatives. The OIG's review disclosed no instances in which Castro did not comply, in all material respects, with *Government Auditing Standards.* Our review, as differentiated from an audit of the financial statements in accordance with U.S. generally accepted government auditing standards, was not intended to enable us to express, and we do not express, opinions on LSC's financial statements, conclusions about compliance with applicable laws and regulations, or the effectiveness of internal controls. Castro is responsible for the attached audit reports, dated May 6, 2019, and the conclusions expressed therein.

Attachment

cc: Jim Sandman
President

Castro & Company
Auditors ✓ Advisors

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Independent Auditor's Report on the Financial Statements

Inspector General and Board of Directors
Legal Services Corporation

We have audited the accompanying financial statements of the Legal Services Corporation (LSC), which comprise the statement of financial position as of September 30, 2018 and 2017, and the related statements of activities and changes in net assets, cash flows, and functional expenses for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the organization's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the organization's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion on the Financial Statements

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of LSC as of September 30, 2018 and 2017, and the related statements of activities and changes in net assets, cash flows, and functional expenses for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter
As discussed in Note 9 to the financial statements, LSC improperly recognized grant expenses during Fiscal Year 2011 and also during Fiscal Years 2013 through 2017. Accordingly, beginning net assets was restated by $8,818,687 to reflect the correction of this error. Our opinion is not modified with respect to this matter.

Report on Other Legal Regulatory Requirements
In accordance with U.S. *Government Auditing Standards,* we have also issued our reports dated May 6, 2019, on our consideration of LSC's internal control over financial reporting and the results of our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters that are required to be reported under *Government Auditing Standards.* The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with U.S. *Government Auditing Standards* in considering LSC's internal control and compliance, and should be read in conjunction with this report in considering the results of our audit.

This report is intended solely for the information and use of management, the Board of Directors, and the LSC Office of Inspector General, and is not intended to be and should not be used by anyone other than these specified parties.

Castro & Company, LLC

May 6, 2019
Alexandria, VA

Legal Services Corporation
Statement of Financial Position
September 30, 2018 and 2017

	2018		(Restated) 2017	
Assets				
Current Assets				
Cash	$	111,339,231	$	89,821,368
Accounts Receivable		39,585		$ (14,048.00)
Grant and Contribution Receivable, net		1,302,401		1,732,178
Prepaid Expenses and Other Assets		308,768		342,018
Total Current Assets		112,989,985		91,881,516
Property and Equipment, net		408,798		213,643
Contributions Receivable		15,000		275,000
Total Assets	**$**	**113,413,783**	**$**	**92,370,159**
Liabilities and Net Assets				
Grants Payable	$	63,697,162	$	66,714,438
Accounts Payable		394,363		419,280
Accrued and Other Liabilities		1,455,420		1,252,112
Deferred Revenue		-		2,549,047
Total Liabilities		**65,546,945**		**70,934,877**
Net Assets				
Unrestricted		10,922,324		10,000,419
Restricted		36,944,514		11,434,863
Total Net Assets		**47,866,838**		**21,435,282**
Total Liabilities and Net Assets	**$**	**113,413,783**	**$**	**92,370,159**

Legal Services Corporation
Statement of Activities and Changes in Net Assets
Year Ended September 30, 2018

	Without Restrictions	With Restrictions	Total
Support and Revenue			
Federal Appropriations	$ 24,725,000	$ 400,275,000	$ 425,000,000
Grant Revenues	-	2,580,000	2,580,000
Contributions	365,234	176,500	541,734
Other Income	142,203	-	142,203
Donated Services	250,000	-	250,000
Net Assets Released from Restriction	380,070,896	(380,070,896)	-
Total Revenue	**$ 405,553,333**	**$ 22,960,604**	**$ 428,513,937**
Expenses			
Program Services			
Grants and Contracts	379,078,555	-	379,078,555
Herbert S. Garten Loan Repayment Assistance Program	1,002,400	-	1,002,400
Supporting Services			
Management and Grants Oversight	19,723,593	-	19,723,593
Office of Inspector General	4,668,400	-	4,668,400
Fundraising	158,480	-	158,480
Total Expenses	**$ 404,631,428**	**$ -**	**$ 404,631,428**
Change in Net Assets	921,905	22,960,604	23,882,509
Net Assets, Beginning of Year	10,000,419	11,434,863	21,435,282
Deferred Revenue Adjustment to Net Assets		2,549,047	2,549,047
Net Assets, End of Year	**$ 10,922,324**	**$ 36,944,514**	**$ 47,866,838**

Legal Services Corporation
Statement of Activities and Changes in Net Assets
Year Ended September 30, 2017

	(Restated) Without Restrictions	(Restated) With Restrictions	(Restated) Total
Support and Revenue			
Federal Appropriations	$ -	$ 385,000,000	$ 385,000,000
Grant Revenues	-	3,345,055	3,345,055
Contributions	-	100,788	100,788
Other Income	14,271	-	14,271
Change in Deferred Revenue	(184,488)	-	(184,488)
Net Assets Released from Restriction	382,929,197	(382,929,197)	-
Total Revenue	**$ 382,758,980**	**$ 5,516,646**	**$ 388,275,626**
Expenses			
Program Services			
Grants and Contracts	357,564,027	-	357,564,027
Herbert S. Garten Loan Repayment Assistance Program	1,022,000	-	1,022,000
Supporting Services			
Management and Grants Oversight	18,921,085	-	18,921,085
Office of Inspector General	4,711,392	-	4,711,392
Fundraising	160,280	-	160,280
Total Expenses	**$ 382,378,784**	**$ -**	**$ 382,378,784**
Change in Net Assets	380,196	5,516,646	5,896,842
Net Assets, Beginning of Year	9,620,223	2,736,427	12,356,650
Prior Period Adjustment	-	3,181,790	3,181,790
Net Assets, End of Year	**$ 10,000,419**	**$ 11,434,863**	**$ 21,435,282**

Legal Services Corporation
Statement of Cash Flows
Years Ended September 30, 2018 and 2017

Cash Flows from Operating Activities		**2018**		**(Restated) 2017**
Change in Net Assets	$	23,882,509	$	5,896,842
Adjustment to Reconcile Changes in Net Assets to Net Cash Provided by Operating Activities:				
Depreciation and Amortization		118,394		97,129
Loss on Disposal of Assets		502		1,969
Change in Assets and Liabilities:				
Accounts Receivable		(53,633)		17,280
Contributions Receivable		796,936		596,460
Prepaid Expenses and Deposits		33,250		(267,604)
Grants Receivable		(107,160)		(1,266,498)
Grants and Contracts Payable		(3,017,274)		(5,017,312)
Accounts Payable		(24,918)		16,406
Accrued Salaries, Vacation, and Other Payroll Liabilities		203,308		(59,778)
Deferred Revenue		-		184,488
Net Cash Used by Operating Activities	$	21,831,914	$	199,382
Cash Flows from Investing Activities				
Purchase of Fixed Assets		(314,051)		(132,703)
Net Cash Used in Investing Activities	**$**	**(314,051)**	**$**	**(132,703)**
Net Increase (Decrease) in Cash and Cash Equivalents		**21,517,863**		**66,679**
Cash and Cash Equivalents, Beginning of Year		**89,821,368**		**89,754,689**
Cash and Cash Equivalents, End of Year	$	111,339,231	$	89,821,368
Supplemental Disclosure of Non-Cash Transactions:				
Prior Period Adjustment for Reversal of Expenses for Technology Initiative Grants & Pro Bono Innovation Grants				
Impact on Grants Receivable	$	867,102	$	-
Impact on Grants Payable	$	7,951,585	$	3,181,790
Total	**$**	**8,818,687**	**$**	**3,181,790**

Legal Services Corporation
Statement of Functional Expenses
September 30, 2018 and 2017

	Program Services		Supporting Services				
	Grants and Contracts	Herbert S. Garten Loan Repayment Assistance Program	Management and Grant Oversight	Office of Inspector General	Fundraising (Institutional Advancement)	2018 Total Expenses	2017 Total Expenses
Compensation and Benefits	$ 93,732	$ -	$ 14,915,074	$3,972,429	$ 131,848	$ 19,113,083	$ 18,397,647
Temporary Personnel	-	-	404,824	-	14,896	419,720	562,105
Consulting	219,857	-	695,456	389,291	-	1,304,604	895,957
Travel	97,923	-	789,625	182,683	5,061	1,075,292	1,006,242
Communications	-	-	93,691	17,119	763	111,573	106,757
Occupancy	-	-	1,807,114	-	-	1,807,114	1,786,675
Printing and Reproduction	-	-	74,197	7,936	-	82,133	88,613
Other Expenses	11,530	1,002,400	819,066	98,942	5,912	1,937,850	851,632
Capital Expenditures	-	-	6,152	-	-	6,152	-
Grants	378,655,513	-	-	-	-	378,655,513	358,586,027
Sub-Total	**379,078,555**	**1,002,400**	**19,605,199**	**4,668,400**	**158,480**	**404,513,034**	**382,281,655**
Depreciation			118,394			118,394	97,129
Total Expenses	**$ 379,078,555**	**$ 1,002,400**	**$ 19,723,593**	**$ 4,668,400**	**$ 158,480**	**$ 404,631,428**	**$ 382,378,784**

Legal Services Corporation
Notes to the Financial Statements
September 30, 2018 and 2017

1. ORGANIZATION AND PURPOSE

Legal Services Corporation (LSC) is a private non-membership District of Columbia nonprofit corporation, established by Congress in the Legal Services Corporation Act of 1974, Public Law 93-355, and amended in 1977 by Public Law 95-222. The purpose of LSC is to provide financial support to independent organizations that directly provide legal assistance in non-criminal proceedings or matters to persons financially unable to afford such counsel.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Financial Presentation

LSC's financial statements are prepared on the accrual basis of accounting. Accordingly, revenue is recognized when earned, and expenses are recorded when incurred in accordance with U.S. Generally Accepted Accounting Principles (U.S.GAAP). LSC recognizes contributions, including unconditional promises to give, as revenue in the period received. Contributions, net assets, and changes therein are classified and reported based on the existence or absence of donor-imposed restrictions.

(b) Cash and Cash Equivalents

LSC considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. LSC maintains its cash and cash equivalents (and certificate of deposits) in financial institutions which, at times may exceed federally insured limits or are uninsured. LSC has not experienced any losses in such accounts. At September 30, 2018 and 2017, LSC had $111,339,231 and $89,821,368, respectively.

(c) Program-Related Investments

LSC makes loans to individuals to receive assistance towards the payment of their eligible law school loans through a program called the'Herbe rt S. Garten Loan Repayment Assistance, which mitigates the economic hardships confronting grantee attorneys, and increases their ability and willingness to stay with legal aid organizations. Loans are measured at fair value at inception and recorded on a net basis to reflect a discount on loan receivables or a reasonable loss reserve. The loss reserve estimate is reviewed on an annual basis and adjusted if collectability risk has significantly changed due to their employment status changing within an LSC funded program.

(d) Fair Value

LSC applies fair value accounting for all financial assets and liabilities that are recognized at fair value in the financial statements. In determining the fair value, LSC utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. The Financial Accounting Standards Board (FASB) established a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level I measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below:

Level 1 - Inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to the reporting entity at the measurement date.

Level 2 - Inputs: Valuations based on observable inputs (other than Level I prices) such as quoted prices for similar assets or liabilities at the measurement date, quoted prices in markets that are not active, or other inputs that are observable, either directly or indirectly.

Level 3 - Inputs: Valuations based on inputs that are unobservable and significant to the overall fair value measurement and involve management judgment.

The carrying value on the statement of financial position of cash, prepaid and other assets, accounts payable, grant payables, and accrued and other liabilities approximates fair value.

(e) Grants and Contributions Receivable

Receivables are carried at original invoice or promise to give amount less an estimate made for doubtful receivables based on a review of all outstanding amounts. Management determines the allowance for doubtful accounts by identifying questionable accounts and by using historical experience applied to an aging of accounts. Receivables are written off when deemed uncollectible.

(f) Property and Equipment

Property and equipment are stated at cost and depreciated using the straight-line method over the estimated useful lives of the assets. Depreciation is reported as an unallocated expense within the management and grants oversight function. LSC annually reviews property and equipment assets for impairment of value and any adjustments necessary to reflect material impacts in value. The estimated useful lives are as follows:

Furniture and Fixtures	10 years
Leasehold Improvements	10 years
Computer Hardware and Software	5 years

(g) Grants Payable

Grant expense is recognized when a payment is made to a grantee, or in the period the grant is countersigned, provided the grant is not subject to significant future conditions. Conditional grants are recognized as grant expense and as a grant payable in the period in which the grantee meets the terms of the conditions.

(h) Conditional Grant Awards

Conditional grant awards are a promise to make future payments upon the grantee's satisfaction of a specified future or uncertain event. LSC recognizes expenses related to conditional grant awards in the financial statements when the conditions on which the awards depend are substantially met and the conditional payments are made. At September 30, 2018 and 2017, commitments related to such grants amounted to $16,152,491 and $15,220,362, respectively. Management expects the grantees will achieve the milestones set forth in the conditional grants and thus the grant amounts will ultimately be recognized as an expense.

(i) Net assets without restrictions

Net assets without restrictions represent unrestricted resources available to support LSC's operations and temporarily restricted resources that become available for use by LSC in accordance with the intentions of the donors. The total unrestricted net asset amount of $10,922,324 as of September 30, 2018 includes $2,540,068 which has been designated by the Board of Directors.

(j) Net assets with restrictions

Net assets with restrictions represent contributions that are limited in use in accordance with donor-imposed stipulations. These stipulations may expire with time or may be satisfied and removed by the actions of LSC according to the terms of the contribution.

(k) Revenue Recognition

LSC receives federal appropriations for Management and Grants Oversight, and Office of Inspector General funding which are reported as revenue in the period the public law makes them available. Unexpended portions of these appropriations are reported as restricted net assets. In addition, LSC receives federal appropriations for Basic Field Programs, Technology Initiatives, Loan Repayment Assistance Program (LRAP), and Pro Bono Innovation. Management considers these earned when LSC has fully executed the related award agreements to third parties. All unconditional contributions are reported as unrestricted support when received in the absence of a donor's explicit stipulation or circumstances surrounding the receipt of the contribution that make clear the donor's restrictions on use. Donor-restricted contributions whose restrictions are met in the same reporting period are reported as unrestricted support.

(l) Contributed services and in-kind contributions

LSC receives contributed services in support of its programs. Certain contributed services meet the criteria for recognition under U.S. GAAP. Contributed services are recognized if the services received either create or enhance long-lived assets, or require specialized skills, are provide by individuals possessing those skills, and would typically need to be purchased if not provided by the donation. For the year ended September 30, 2018, contributed services totaled $250,000, and are included in donated services revenue and program expenses in the statement of activities.

(m) Concentration of Risk

LSC receives substantially all its revenue from direct federal government appropriations. Should there be a significant reduction in this revenue, LSC's programs and activities could be negatively affected.

(n) Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect reported amounts and disclosures. Accordingly, actual results may differ from those estimates. Significant estimates include the discounting of the allowance for loans in the loan repayment assistance program.

(o) Tax Exempt Status

LSC is exempt from federal income tax under the provisions of Section 50l(c)(3) of the Internal Revenue Code and the applicable income tax regulations of the District of Columbia. Income, which is not related to its exempt purpose, less applicable deductions, is subject to federal and state corporate income taxes. LSC had unrelated business income for the year ended September 30, 2018.

(p) Recent Accounting Pronouncements

In August 2016, the FASB issued Accounting Standards Update (ASU) 2016-14 - Not-for-profit Entities (Topic 958) *Presentation of Financial Statements of Not-for-profit Entities*. The amendment set forth the FASB's changes to net asset classification requirements and the information presented about a not-for-profit entity's endowment funds, liquidity, financial performance, and cash flows. The ASU 2016-14 will be effective for fiscal years beginning after December 15, 2018. The accompanying statements include early adoption of the amendment.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic). Under the new guidance, lessees are required to recognize lease assets and lease liabilities on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2019. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. LSC is currently evaluating the impact of the pending adoption of this standard on its financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606) along with various updates in 2016 and 2015, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S.GAAP when it becomes effective and permits the use of either a full retrospective or retrospective with cumulative effect transition method. Early adoption is not permitted. The updated standard will be effective for annual reporting periods beginning after December 15, 2018. LSC is currently evaluating the impact of the pending adoption of this standard on its financial statements.

In June 2018, the FASB issued ASU 2018-08, Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made, which provides additional guidance on characterizing grants and similar contracts with resource providers as either exchange transactions or contributions, as well as distinguishing between conditional contributions and unconditional contributions. The updated standard will be effective for resource recipients for annual reporting periods beginning after December 15, 2018. LSC is currently evaluating the impact of the pending adoption of the new standard on the financial statements.

3. PROPERTY AND EQUIPMENT

Property and equipment consists of the following at September 30, 2018:

	Beginning Balance	**Additions**	**Disposals**	**Ending Balance**
Furniture and Equipment	$ 1,658,189	$ 314,051	$ (211,260)	$ 1,760,980
Software	610,235		(572,201)	38,034
Leasehold Improvements	13,095			13,095
Subtotal	2,281,519	314,051	(783,461)	1,812,109
Less: Accumulated Depreciated and Amortization	{2,067,876}	{118,394}	782,959	{1,403,311}
Net Fixed Assets	**$ 213,634**	**$ 195,657**	**$ (502)**	**$ 408,798**

Property and equipment consists of the following at September 30, 2017:

	Beginning Balance	**Additions**	**Disposals**	**Ending Balance**
Furniture and Equipment	$ 1,646,273	$ 104,627	$ (92,711)	$ 1,658,189
Software	584,549	25,686		610,235
Leasehold Improvements	10,705	2,390		13,095
Subtotal	2,241,527	132,703	(92,711)	2,281,519
Less: Accumulated Depreciated and Amortization	{2,061,489}	{97,129}	90,742	{2,067,876}
Net Fixed Assets	**$ 180,038**	**$ 35,574**	**$!1,969)**	**$ 213,643**

Depreciation and amortization expense for the years ended September 30, 2018 and 2017 was $118,394 and $97,129, respectively.

4. GRANTS AND CONTRIBUTIONS RECEIVABLE

LSC operates under various federal appropriation and grants from private sources. At September 30, 2018 and 2017, grants and contribution receivable consist of the following:

	2018		2017	
Program Specific	$	974,261	$	1,332,782
Other Private Grant Contributions		328,140		399,396
Total	**$**	**1,302,401**	$	**1,732,178**

As of September 30, 2018, all grants and contributions receivable are expected to be collected within one year.

5. RETIREMENT PLANS

Pursuant to the Legal Services Corporation Act, all officers and employees hired before October 1, 1988, are participants in the Civil Service Retirement System (CSRS), although they are neither officers nor employees of the federal government. The CSRS plan is administered by the United States Office of Personnel Management (OPM).

LSC makes CSRS contributions at rates applicable to agencies of the federal government. The contributions do not equal the full-service cost of the pension expense, which is the actuarial present value of benefits attributed to services rendered by covered employees during the accounting period. The measurement of service cost requires the use of actuarial cost methods to determine the percentage of the employees' basic compensation sufficient to fund their projected pension benefit. These percentages (cost factors) are provided by OPM and the excess of total pension expense over the amount contributed by LSC and by LSC employees represents the amount that must be financed directly by OPM. Post-retirement CSRS benefits are paid by OPM. No amounts have been recognized in the financial statements for these imputed costs. LSC does not report in its financial statements CSRS assets, accumulated plan benefits or unfunded liabilities, if any, applicable to its employees.

All officers and employees hired after September 30, 1988, are ineligible for the CSRS plan, but they are eligible to participate in LSC's pension and thrift plan, which is a tax deferred annuity plan subject to Section 403(b) of the Internal Revenue Code. LSC contributes 6 percent of each eligible employee's salary regardless of their participation. In addition, LSC matches the first 2.51 percent contributed by the employee. Individuals can make contributions up to the maximum amount permitted under federal income tax rules.

LSC's contributions to these plans for the years ended September 30, 2018 and 2017 were $1,202,007 and $1,209,333, respectively. The amounts are included in compensation and benefits on the accompanying statement of functional expenses.

LSC also offers tax deferred annuity savings plans. CSRS eligible employees may contribute pretax earnings to the federal Thrift Savings Plan, and 403(b) eligible employees may contribute additional pretax earnings to the Section 403(b) plan. These plans are subject to different maximum amounts as permitted by the prevailing laws. No contributions are made to these tax deferred savings plans by LSC.

6. LEASE COMMITMENTS

In September 2012, LSC renewed its lease agreement for an additional 10 years commencing on June 1, 2013. Under the lease, LSC has an obligation to pay a portion of building operating expenses in excess of the base year. The pass-through costs for the fiscal years ended September 30, 2018 and 2017 were $74,931 and $63,507, respectively. LSC has the right to terminate the lease by giving no less than 120-day prior written notice if LSC does not receive an appropriation from Congress for administrative costs sufficient to cover LSC and its rental obligations for any period during the term of the lease.

Future minimum lease payments as of September 30, 2018, are as follows:

Fiscal Year	Amount
2019	$ 1,710,000
2020	1,710,000
2021	1,710,000
2022	1,710,000
2023	1,140,000
Total	**$ 7,980,000**

Rental expense for the years ended September 30, 2018 and 2017 was $1,784,931 and $1,773,057, respectively. '

7. NET ASSETS WITH RESTRICTIONS

Components of temporarily restricted net assets at September 30, 2018 were as follows:

	2018	2017
Emergency Disaster Relief	$ 14,983,313	$
Technology Initiative Grant	10,179,997	5,718, 974
Pro Bono Innovation	7,543,427	3,099,713
Loan Repayment Assistance	1,457,642	
40th Anniversary Campaign	937,690	2,009,918
Rural Summer League Corp	625,366	
Basic Field Grants	568,259	
The Margaret A. Cargil1 Foundation	251,363	524,755
Business Community Campaign	107,500	
Vieth Grant	100,000	
U.S. Court of Veterans Appeals	70,343	

Hurricane Sandy Disaster Relief	54,558	54,558
Private Grants	65,056	
Andrew W. Mellon Foundation		14,580
Public Welfare Foundation		12,365
Total	**$ 36,944,514**	**$ 11,434,863**

8. SUBSEQUENT EVENTS

LSC has evaluated subsequent events occurring after the statement of financial position date through the date of May 6, 2019, the date the financial statements were available for issuance and determined that no additional disclosures are required.

9. PRIOR PERIOD ADJUSTMENT

During the fiscal year ended September 30, 2018, LSC discovered that it had improperly recognized expenses in prior periods. The correction of this error increased opening net assets by $8,818,687 and required a restatement of fiscal year 2017 financial statements as reflected in the Statements of Financial Position, Statement of Activities and Changes in Net Assets, and Cash Flow Statement.

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Independent Auditor's Report on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Inspector Genera] and Board of Directors
Legal Services Corporation

We have audited the financial statements of the Legal Services Corporation (LSC), which comprise the statement of financial position as of September 30, 2018 and 2017, and the related statements of activities and changes in net assets, cash flows, and functional expenses for the years then ended, and the related notes to the financial statements, and have issued our report thereon dated May 6, 2019. We conducted our audit in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller Genera] of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements as of and for the year ended September 30, 2018, we considered LSC's internal control over financial reporting by obtaining an understanding of the design effectiveness of LSC's internal control, determining whether controls had been placed in operation, assessing control risk, and performing tests of LSC's controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not to express an opinion on the effectiveness of LSC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of LSC's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over financial reporting was for the limited purposes described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control over financial reporting that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be significant deficiencies. We did identify one deficiency in internal control, described below, that we consider to be a material weakness.

LSC's Response to Findings

LSC's response to the finding identified in our audit is described in Appendix A. LSC's response was not subject to auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

We noted less significant matters involving internal control and its operations which we have reported to LSC management in a separate letter dated May 6, 2019.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and the result of that testing, and not to provide an opinion on the effectiveness of LSC's internal control. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering LSC's internal control. Accordingly, this communication is not suitable for any other purpose.

This report is intended solely for the information and use of management, the Board of Directors, and the LSC Office of Inspector General, and is not intended to be and should not be used by anyone other than these specified parties.

Castro & Company, LLC

May 6, 2019
Alexandria, VA

MATERIAL WEAKNESSES

1. **Sufficient Accounting Resources and/or Personnel with Appropriate Skill Sets and Quality Control Procedures are Needed to Promptly Identify Financial Reporting and Accounting Discrepancies**

During the course of our audit and discussions with LSC management regarding the financial statement preparation process and the supporting procedures of accounting transactions, LSC management noted errors that were not timely detected by the internal controls of the organization. Based on further analysis, LSC management determined that these issues occurred and went undetected as a result of:

- a lack of segregation of financial reporting tasks;
- ineffective and/or inconsistent management reviews and approvals to provide assurance that transactions and adjustments were accurate and properly supported; and
- a lack of documented policies and procedures for financial reporting functions.

LSC management identified and made the necessary prior period adjustment to the issued financial statements to correct the effect of the material error.

During our audit, it was apparent that LSC management did not cross-train personnel to perform day-to-day financial accounting, reporting, and analytical tasks. Additionally, the Office of Financial & Administrative Services (OFAS) does not have the appropriate resources to implement financial statement reporting requirements or sufficient controls in place to ensure that the financial statements are thoroughly prepared, reviewed, and presented in accordance with the U.S. Generally Accepted Accounting Principles, and does not have appropriate quality control procedures in place to timely detect certain financial reporting and accounting errors. In October 2018, LSC hired an Interim Comptroller to assist with the fiscal year (FY) 2018 Financial Statement Audit and preparation of the FY 2018 financial statements during the absence of LSC's Comptroller and Treasurer. The Interim Comptroller came to LSC with a fresh perspective, and while obtaining an understanding of the organization and re-examining the financial reporting processes, accounting and financial reporting discrepancies were identified that had gone undetected for several fiscal years, which resulted in the recording of a prior period adjustment to make the necessary correction to previously issued financial statements.

<u>Prior Period Adjustment</u>

During FY 2018, LSC evaluated and discussed with the auditors the new Accounting Standards Update (ASU) 2018-08, Not-For-Profit Entities (Topic 958) - Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made. During LSC management's discussion of the ASU with the auditors, LSC management determined that the entire amount of advances given to grantees had erroneously been recorded as an expense rather than as a receivable. The material error went back several accounting periods and as a result, it was determined by LSC management and the auditors that a prior period adjustment was needed to make the correction. As a result, the beginning net assets balance for FY 2018 was adjusted by $8,818,687. This adjustment affected the Pro Bono Initiative Fund by $3,099,713 and the Technology Initiative Grant by $5,718,974 dating back to FY 2011.

Implementing multiple levels of review and appropriate segregation of duties is needed to ensure that these types of material errors are identified and corrected in a timely manner.

The Government Accountability's Office (GAO) Standards for Internal Control in the Federal Government states,

> Personnel need to possess and maintain a level of competence that allows them to accomplish their assigned responsibilities, as well as understand the importance of effective internal control. Holding individuals accountable to established policies by evaluating personnel's competence is integral to attracting, developing, and retaining individuals.
>
> Management performs ongoing monitoring of the design and operating effectiveness of the internal control system as part of the normal course of operations. Ongoing monitoring includes regular management and supervisory activities, comparisons, reconciliations, and other routine actions.
>
> Management clearly documents internal control and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination.
>
> Management designs appropriate types of control activities for the entity's internal control system. Control activities help management fulfill responsibilities and address identified risk responses in the internal control system ...
>
> Management may design a variety of controls activities for operational processes, which may include verifications, reconciliations, authorizations and approvals, physical control activities, and supervisory control activities.

In September 2018, LSC's Comptroller and Treasurer took an extended leave of absence. LSC's Comptroller and Treasurer had been responsible for the preparation and review of the financial statements along with supporting schedules; however, sufficient desk manuals or policies and procedures were not documented or maintained to serve as guidance on how those functions were to be performed in the event of his absence. LSC became overly dependent on the Comptroller and Treasurer performing financial reporting tasks, and as a result, the accounting staff were put into roles where they either did not have adequate knowledge or were unfamiliar with the financial reporting processes. Therefore, it presented a challenge for LSC management to close out accounts and prepare the FY 2018 financial statements in a timely manner during the absence of the Comptroller and Treasurer.

An over-dependence on key personnel within the finance office has the potential to lead to knowledge and skillset gaps within the office during periods where key personnel are absent. As a result, the vacancy may hinder the accounting and financial reporting team's ability to effectively manage the financial operations of the Corporation and ensure the reliability of financial reporting. Additionally, a lack of adequate cross-training of LSC's financial reporting team will continue to result in challenges in its accounting and financial reporting processes. For instance, without sufficient and adequately trained accounting staff to carry out LSC's financial reporting tasks, the detailed work may not be performed correctly, which may result in potential errors to the financial statements. Effective management oversight and the performance of quality control procedures greatly increases LSC's ability to proactively identify and resolve issues that could result in misstatements in accounting and financial reporting records.

Recommendations:

We recommend that LSC management:

1. Review its organizational structure to ensure that the Office of Financial & Administrative Services is adequately staffed with individuals that possess adequate experience compiling financial statements and recording accounting transactions, to enhance LSC's ability to produce accurate and timely financial reports and schedules. Once the review is complete, corrective action should be taken to address any deficiencies identified in current staffing levels or competencies.

2. Create a key personnel succession plan to support all financial reporting functions. Without a fully structured succession plan, OFAS hires staff as vacancies occur. As a result, OFAS as a whole, cannot adequately ensure continuity of leadership, address challenges, and implement a strategic alignment for carrying out its financial reporting functions. Furthermore, there could be a gap of institutional knowledge and expertise.

3. Develop and provide on-going training and cross-training to LSC accounting staff on accounting and reporting requirements to enhance LSC's ability to compile financial statements and related schedules accurately and timely.

4. Develop a process for in-depth management quality control reviews of the financial statements and notes, journal vouchers, and accounting transactions to ensure they are properly and timely reported and recorded, as well developing and implementing policies and procedures to ensure accountability, monitoring and oversight of accounting and reporting functions.

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Independent Auditor's Report on Compliance and Other Matters on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Inspector General and Board of Directors
Legal Services Corporation

We have audited the financial statements of the Legal Services Corporation (LSC), which comprise the statement of financial position as of September 30, 2018 and 2017, and the related statements of activities and changes in net assets, cash flows, and functional expenses for the years then ended, and the related notes to the financial statements, and have issued our report thereon dated May 6, 2019. We conducted our audit in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

The management of LSC is responsible for complying with laws and regulations applicable to LSC. We performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether LSC's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with these provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests of compliance disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of compliance and the result of that testing, and not to provide an opinion on LSC's compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering LSC's compliance. Accordingly, this communication is not suitable for any other purpose.

This report is intended solely for the information and use of management, the Board of Directors, and the LSC Office of Inspector General, and is not intended to be and should not be used by anyone other than these specified parties.

Castro & Company, LLC

May 6, 2019
Alexandria, VA

APPENDIX A - LSC's RESPONSE TO AUDIT FINDING

LSC | America's Partner for Equal Justice
LEGAL SERVICES CORPORATION

MEMORANDUM

TO: Millie Seijo. CPA Castro & Company. LLS

FROM: James J Sandman, President
Deborah Moore. Treasurer and Chief Financial Officer

DATE: April 7. 2019

SUBJECT: Management Response to Independent Auditor's Report on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Please insert the following as management's response to the Independent Auditor's Report on Internal Control, page 22:

Background

Management takes seriously its obligation to present fairly, in all material respects, its financial position on an annual basis. Independent auditors· reports from 1975 to 2018 have uniformly concluded that LSC's financial statements have met this standard. To identify areas for improvement in its financial management and accounting. LSC retained financial business process consultant. PKF O'Connor Davies, on July 21. 2017, to conduct an analysis of the Office of Financial and Administrative Services' (OFAS's) financial business and workflow processes. PKF presented its final report and recommendations to LSC on September 20, 2017, and LSC began implementing the: recommendations in 2018. In September 2018, shortly before the end of LSG's fiscal year, LSC's long-time (31 years) Comptroller/Treasurer unexpectedly took an extended leave of absence. LSC promptly hired an Interim Comptroller in October 2018. In January 2019, the Interim Comptroller was appointed as LSCs Chief Financial Officer and Treasurer.

Shortly after joining the Corporation, LSC's then-Interim Comptroller recognized issues in OFAS's structure and operations, many of which had been the subject of the O'Connor Davies recommendations. More specifically, she recognized that LSC needed to: (1) review its organizational structure to ensure that OFAS was adequately staffed. (2) create a personnel succession plan to support financial reporting functions to ensure continuity of knowledge regarding those functions, (3) provide training and cross-training to LSC accounting staff on accounting and reporting requirements to enhance LSC's financial reporting and ensure continuity of knowledge regarding that function, and (4) improve quality control review of the financial statements and notes, journal vouchers, and accounting transactions. She shared her views with Castro & Company (Castro) during the audit process, and Castro's recommendations in the Report on Internal Control reflect these same issues. The then-Interim Comptroller (now CFO) immediately began to take steps to address these issues.

During the final stages of preparing the FY 2018 financial statements for Castro's review, LSC management identified an accounting error. During the evaluation of the new Accounting Standards Update (ASU) 2018-0S, Not-For-Profit Entities - Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made, LSC determined that, in 2018 and prior periods, the payments to be made to recipients of Technology Initiative Grants and Pro Bono Innovation Grants were misclassified as an expense recognized at the outset of the grant award rather than as a receivable removed from the books and .recognized as an expense as designated milestones were met during the life of the grant. The then-Interim Comptroller reported the issue to Castro, who concurred with LSC's treatment of the issue.

Prior Period Adjustment

Castro has advised LSC management they believe the adjustment related to accounting for conditional or "milestone grants" is material enough to warrant a prior period adjustment and that LSC's failure to detect the issue on a timely basis indicates a material weakness in internal control. We would like to point out that LSC management itself identified this issue and brought it to the attention Castro. Management understands Castro's rationale and has taken and is taking steps to ensure that nothing like this occurs again. Further the matter relates to Technology Initiative Grants (TIG) and Pro Bono Innovation Fund (PBIF) grants only, which currently represent just over 2% of LSCs grant funds. With the recent change in personnel in LSC's accounting function, we are not able to determine exactly how the original accounting decision was made on the conditional grants in 2013. It may well have been considered immaterial at the time, when the TIG funding was lower than it is today and the PBIF grant funds did not yet exist. Management believes that whatever determination was made at the time should have been revisited and was not until LSC's then Interim Comptroller investigated the matter in connection with closing the books for 2018 and preparing for the annual audit. We would also add that the specific internal control weakness at issue relates to financial reporting only and not to the stewardship of assets. Neither management, the OIG, or our outside auditors have found any reason to question the adequacy of our internal controls related to the custody of assets.

Management Response to the Report Recommendations

LSC management concurs in Castro's recommendations. Castro's recommendations address conditions that management itself previously identified and is in the process of addressing.

Recommendation #l: "Review its organizational structure to ensure that the Office of Financial & Administrative Services is adequately staffed with individuals that possess adequate experience compiling financial statements and recording accounting transactions, to enhance LSC's ,ability to produce accurate and timely financial reports and schedules. Once the review is complete, corrective action should be taken to address any deficiencies identified in current staffing levels or competencies."

Comment: Management agrees. LSC is reviewing the organizational structure in the Office of Financial and Administrative Services to ensure it is adequately staffed with individuals who possess adequate expertise and knowledge. We are currently reviewing the needs of the department and identifying which employees are best equipped to handle specific functions and what additional training and support they might need.

Recommendation #2: "Create a key personnel .succession plan to support all financial reporting functions. Without a fully structured succession plan. OFAS hires staff as vacancies occur. As a result, OFAS, as a whole, cannot adequately ensure continuity of leadership, address challenges, and implement a strategic alignment for carrying out its financial reporting functions. Furthermore, there could be a gap of institutional knowledge and expertise."

Comment: Management agrees. Management believes the effective and efficient operation of OFAS is essential to LSC's overall success. LSC intends to create a succession plan for key positions within the department. As part of the organizational structure review, we are identifying risks that would affect the continuity of OFAS operation. Management will determine which positions are critical to the department's continued operations as well as the requisite skills and experience required for successor candidates.

Recommendation #3: "Develop and provide on-going training and cross-training to LSC accounting staff on accounting and reporting requirements to enhance LSC's ability to compile financial statements and related schedules accurately and timely."

Comment: Management agrees. It is important to have jobs in OFAS periodically performed by others to help with process improvements and bring fresh perspectives to day-to-day operations. As we review the organizational structure, policies and procedures, OFAS will incorporate cross-training to enhance LSC's ability to complete tasks accurately and timely, even one or more employees are absent from the office.

Recommendation #4: "Develop a process for in-depth management quality control reviews of the financial statements and notes, journal vouchers, and accounting transactions to ensure they are properly and timely reported and recorded, as well developing and implementing policies and procedures to ensure accountability, monitoring, and oversight of accounting and reporting functions."

Comment: Management agrees. LSC is replacing, on an expedited basis, its 20-year old accounting system. Accounting systems are not changed or replaced very often. As LSC has grown in size and complexity, the organization has reached a point where we need to modernize our accounting systems. New accounting systems geared toward middle-market organizations such as LSC have features and capabilities that were previously available only in more expensive enterprise-level systems. A new system will help OFAS streamline the process of closing LSCs books with the ability to detect and respond to issues at the earliest point possible. Additionally, new systems help ensure compliance with accounting standards and government regulations. They use rule-based reporting capabilities to produce financial reports in accordance with accounting standards and provide extensive audit trail visibility into detailed transaction history that will assist management in performing quality control reviews.

APPENDIX B - AUDITOR'S RESPONSE TO AUDIT FINDING

Castro stands by the Material Weakness as reported in the Internal Control Report, and we reiterate our recommendations provided to management.