



STATE OF NORTH CAROLINA

NORTH CAROLINA STATE BAR

FINANCIAL RELATED AUDIT

JUNE 2013

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

NORTH CAROLINA STATE BAR

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NORTH CAROLINA STATE BAR COUNCIL

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AUDITOR'S TRANSMITTAL

June 27, 2013

The Honorable Pat McCrory, Governor
The General Assembly of North Carolina
North Carolina State Bar Council and North Carolina State Bar IOLTA Board of Trustees
Thomas Lunsford II, North Carolina State Bar Executive Director

This report presents the results of our financial related audit at the North Carolina State Bar. Our work was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes* and was conducted in accordance with the performance audit standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

The results of our audit disclosed deficiencies in internal control and/or instances of noncompliance or other matters that are considered reportable under *Government Auditing Standards*. These items are described in the *Audit Findings and Responses* section of this report.

North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the ways listed in the back of this report.

A handwritten signature in cursive script that reads "Beth A. Wood".

Beth A. Wood, CPA
State Auditor

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BACKGROUND

As authorized by Article 5A of Chapter 147 of the *North Carolina General Statutes*, we have conducted a financial related audit at the North Carolina State Bar (State Bar). There were no special circumstances that caused us to conduct the audit, but rather it was performed as part of our effort to periodically examine and report on the financial practices of state agencies and institutions.

The State Bar is the state agency responsible for the regulation of lawyers who are licensed in North Carolina. The State Bar is governed by a 62-member council, but daily operations are carried out by a staff of over 80 employees. Their responsibilities include investigating and prosecuting lawyers who violate the State Bar's code of ethics for lawyers. In addition, the State Bar promotes the competency of lawyers and paralegals; adopts the code of ethics for lawyers; counsels lawyers on how to follow the rules; resolves fee disputes between lawyers and clients; prevents the practice of law by people who are not licensed; and compensates clients who were the victims of lawyer theft.

All active members of the State Bar are required to pay annual membership and other various fees as set by the Council. These fees provide the revenue to operate the State Bar. Any member who fails to pay the required fees shall be subject to a penalty in an amount determined by the Council.

Within the umbrella of the State Bar is the Interest on Lawyers' Trust Accounts (IOLTA) program. IOLTA is a non-profit program established by the State Bar and the North Carolina Supreme Court to generate income from lawyers' trust accounts to fund programs for the public's benefit. The IOLTA program's primary funding source is interest earned on general trust accounts established by lawyers or interest earned on trust or escrow accounts maintained by settlement agents; voluntary contributions from lawyers; and the interest earned on the program's investments. Members of the IOLTA Board of Trustees are appointed by the State Bar Council to administer and carry out the provisions of the program.

IOLTA funds are used to pay the administrative costs of the program and fund grants approved by the IOLTA Board of Trustees. In accordance with *North Carolina Administrative Code*, grants are awarded to organizations concerned with improving the administration of justice. For example, such grants have provided for the following:

- a. Legal assistance to at-risk children, the elderly, the disabled, and the poor in need of basic necessities;
- b. Services to help lawyers connect with those who need pro bono assistance;
- c. Needed interpreter services;
- d. Summer internships for law students;
- e. Training to local officials on safe and humane jails;
- f. Judicial education to North Carolina judges; and
- g. Student loans to young lawyers in public practice.

AUDIT SCOPE AND OBJECTIVES

The general objective of this financial related audit was to identify improvements needed in internal control over selected fiscal matters. Management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that relevant objectives are achieved. Errors or fraud may nevertheless occur and not be detected because of the inherent limitations of internal control. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or that compliance with policies and procedures may deteriorate. Our audit does not provide a basis for rendering an opinion on internal control, and consequently, we have not issued such an opinion.

Our audit scope covered the period January 1, 2012 through October 31, 2012 and included selected internal controls in the following organizational units:

Accounting - The accounting staff is responsible for all accounting functions of the State Bar. Duties of the accounting staff include depositing and recording membership fees.

Membership Records - Annually, each active member is assessed a \$300 membership fee, a \$25 client security fund assessment, and a \$50 surcharge. The membership records staff is responsible for ensuring that active members pay the required fees. They also ensure a \$30 penalty fee is assessed on any active member who fails to pay dues by the due date.

IOLTA Program Staff - The Executive Director and staff of the IOLTA program work with banks and lawyers across the state to collect net interest income generated from the pooled trust accounts that lawyers must maintain for client funds and uses this income to fund programs that improve the administration of justice. The income collected by IOLTA program is distributed in the form of grants as determined by the Board of Trustees. The Board and program staff is responsible for monitoring grantees to ensure that funds awarded are used in accordance with grant requirements.

During our audit, we considered internal control in the organizational units listed above related to the following accounts/control objectives:

Dues and Penalty Fees – During our audit period, the State Bar collected approximately \$7.4 million in dues and penalty fees. We examined the State Bar’s procedures to ensure:

- a. Membership and late fees are set using a reasonable methodology and are in compliance with state law;
- b. The appropriate amount of annual membership fee, surcharge, and client security fund assessment is charged to and collected from every active member;
- c. Delinquent payments are identified and an appropriate late fee is assessed;
- d. Waived or rebated assessments are appropriate and allowed by state law;
- e. The surcharge is properly remitted to the State Board of Elections as required by state law;

AUDIT SCOPE AND OBJECTIVES (CONCLUDED)

- f. Receipts are safeguarded prior to deposit; and
- g. The duties of receipting, depositing, and reconciling receipts are properly segregated.

We evaluated the design of internal control over all these matters; however, we did not perform detailed audit procedures on waivers/rebates and the remittance of the surcharge to the State Board of Elections.

Interest from IOLTA Participants – During our audit period, the IOLTA program collected approximately \$1.4 million in interest income from lawyers' trust accounts. We examined procedures to ensure every applicable lawyer and settlement agent established interest/dividend bearing accounts at approved banks and that those accounts are monitored to ensure all interest earned is submitted to IOLTA and deposited timely. In addition, we examined procedures to ensure approved banks provide the highest interest rates available. We evaluated the design of internal control over all these matters; however, we did not perform detailed audit procedures on these objectives.

IOLTA Grant Awards - During our audit period, the IOLTA Board of Trustees awarded \$2.4 million to organizations that provide legal services. We examined procedures of the IOLTA program to ensure grants were awarded for the types of programs detailed in the State Bar section of the North Carolina Administrative Code and that the amount awarded was reasonable. We also examined IOLTA's procedures for monitoring grantees for compliance with grant requirements. We evaluated the design of internal control over all these matters; however, we only performed detailed audit procedures on the monitoring of grantees.

METHODOLOGY

To accomplish our audit objectives, we gained an understanding of internal control over matters described in the *Audit Scope and Objectives* section of this report and evaluated the design of the internal control. For certain objectives, we then performed further audit procedures consisting of tests of control effectiveness and/or substantive procedures that provide evidence about our audit objectives. Specifically, we interviewed personnel, observed operations, reviewed policies, analyzed accounting records, and examined documentation supporting recorded transactions and balances, as considered necessary in the circumstances. Whenever sampling was used, we applied a nonstatistical approach but chose sample sizes comparable to those that would have been determined statistically. As a result, we were able to project our results to the population but not quantify the sampling risk.

As a basis for evaluating internal control, we applied the internal control guidance contained in professional auditing standards. As discussed in the standards, internal control consists of five interrelated components: (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring.

We conducted this audit in accordance with generally accepted government auditing standards applicable to performance audits. 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.

RESULTS AND CONCLUSIONS

The results of our audit disclosed deficiencies in internal control and instances of noncompliance or other matters that are considered reportable under generally accepted government auditing standards. These items are described in the *Audit Findings and Responses* section of this report. Management's responses are presented after each audit finding. We did not audit the responses, and accordingly, we express no opinion on them.

AUDIT FINDINGS AND RESPONSES

1. CASH RECEIPTS NOT ADEQUATELY SAFEGUARDED

The North Carolina State Bar does not deposit checks received for the Interest on Lawyers Trust Accounts (IOLTA) program daily and does not store the undeposited checks in a secure place prior to deposit. As a result, there is an increased risk that the checks will be lost or misappropriated and interest income is not maximized. *North Carolina General Statute 147-86.10* requires that procedures be in place to maximize interest earnings.

Currently, the checks received for the IOLTA program are deposited at least once per week. Prior to deposit, checks are kept in an unlocked desk drawer. While the office in which the desk resides is locked at night, the door remains unlocked during working hours.

Recommendation: The State Bar should strengthen internal control over IOLTA program receipts. Management should consider depositing checks daily or establishing a maximum amount of receipts that can be on hand without making a deposit. In addition, undeposited receipts should be stored in a secure location to protect against theft or loss.

State Bar Response: In response to your audit finding, all checks received are now kept in a locked drawer and stamped "For Deposit Only to IOLTA". The IOLTA board has reviewed and approved procedures designed to ensure that any income received by check is maximized. Additionally, IOLTA staff continues to work towards completely eliminating receipt of paper checks by having funds transmitted electronically.

2. MONITORING OF GRANTEE ACTIVITIES AND OUTCOMES NEEDS IMPROVEMENT

The Interest on Lawyers' Trust Accounts Board of Trustees (the Board), a standing committee of the North Carolina State Bar, has not adequately monitored grant recipients. The *North Carolina Administrative Code* requires that state-funded grants be monitored for compliance with grant requirements. Monitoring should include a comparison of actual program results and outcomes to pre-established performance goals. Inadequate monitoring increases the risk of waste and/or misuse of funds.

Review of Grantee Reports

The Board is responsible for approving grants to qualified applicants under the Interest on Lawyers' Trust Accounts (IOLTA) program. The primary procedure used to monitor the use of the funds is to review grantee reports, typically submitted quarterly. However, the Board does not perform procedures to validate the information in the reports, and these reports are not audited by independent auditors.

We reviewed performance and financial reports submitted by two grantees that were awarded 79% of the total funds awarded by the Board. We found that the reports adequately explained how the grant funds were spent, and assuming valid information

AUDIT FINDINGS AND RESPONSES (CONTINUED)

was provided, the reports indicated that the funds were spent in accordance with grant requirements. However, without some type of independent verification of the information in the reports, the Board does not have sufficient assurance that the grant funds were actually used for allowable purposes or achieved stated outcomes.

Review of Audit Reports

Also as part of its monitoring procedures, the Board obtains and reviews grantees' audit reports. We determined that the largest grantee's audit (accounting for 58% of total IOLTA grant awards) included testing to ensure IOLTA funds were spent in accordance with grant requirements. However, the Board was unable to provide evidence that the other grantees' financial and/or compliance audits included testing of the IOLTA funds for grant compliance.

Obtaining grantees' independent audit reports can be a component of monitoring, and such audits may reduce the risk of noncompliance with grant requirements. However, the audits are not an effective monitoring tool if the Board cannot determine that the audits include compliance testing of the IOLTA grant. Also, an independent audit does not determine that program results and outcomes are achieved; and therefore, the Board must execute its own procedures to ensure that this goal is met.

Recommendation: The Board should strengthen its monitoring of grants by including procedures to validate the reported use of funds and performance outcomes. Available options for improving monitoring include requiring grantees to submit documentation supporting reported information or performing site visits. We believe that on-site monitoring is generally the most effective form of monitoring. During a site visit, monitors have the opportunity to interview personnel and observe operations first-hand. Furthermore, monitors can inspect original documentation supporting the use of funds and performance outcomes, which is more reliable than reviewing copies. When site visits are used, the grantor should use standardized procedures for performing and documenting the reviews.

State Bar Response: The IOLTA staff and board are reviewing and revising grant monitoring protocols which will include standardized procedures for validating and documenting the reported use of funds and performance outcomes. These revised protocols will be implemented by the time of the next grant cycle.

3. DEFICIENCIES IN INTERNAL CONTROL OVER DATABASE ACCESS

The North Carolina State Bar does not have adequate access controls in place for the North Carolina State Bar Membership Database (database). This increases the risk that unauthorized individuals could gain access to database information and intentionally or unintentionally read, add, modify, or delete data.

AUDIT FINDINGS AND RESPONSES (CONCLUDED)

The database includes information about members of the State Bar and allows the State Bar to track whether members have paid required dues and other types of fees. Our review of the access controls over this database identified the following deficiencies:

- The State Bar has not performed regular reviews of user access levels. A review is only performed if requested by the membership director or upper management. There was no documentation of a review being requested during our audit period, and management indicated that the last review was over two years ago. Without a regular review of user access, staff could have privileges that are not required by their current job function and such access could remain undetected for extended periods of time. We identified two employees with “write access” (the ability to change data) to the database that is not required by their job duties. However, we did not identify any instances in which these employees altered information within the database.
- The process for granting “write access” to the database is typically granted to new employees upon the membership director’s or upper management’s request and approval. However, access may also be granted based on the predecessor employee’s access privileges. This is not a preferred practice as there could be situations when the predecessor and successor job duties are not identical. We identified one new employee whose “write access” was granted based on the predecessor’s access.

The State of North Carolina’s *Statewide Information Security Manual* requires access to be controlled and managed to ensure only authorized personnel have access and to prevent users from having access that is not required by their job function. The manual also requires that a semi-annual review of users’ rights be performed and documented.

Recommendation: The State Bar should perform semi-annual user access reviews to ensure that all assigned access rights are required by the users to complete their job duties. Further, the State Bar should only grant access rights based on documented requests approved by the appropriate level of management.

State Bar Response: The North Carolina State Bar agrees with the State Auditor that control of electronic database access can and should be improved. To this end, we will comply with the recommendations set forth in the State of North Carolina’s *Statewide Information Security Manual* and review our access and permissions at least semi-annually. All changes in access and permissions will be documented. Senior management will be personally involved in the semi-annual reviews and in all decisions involving permission to access and/or modify the database.

ORDERING INFORMATION

Copies of this report may be obtained by contacting the:

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This audit required 665 audit hours at a cost of \$47,880.