



OFFICE OF THE CITY AUDITOR
Long Beach, California

R-19

LAURA L. DOUD, CPA
City Auditor

June 17, 2008

HONORABLE MAYOR AND CITY COUNCIL
City of Long Beach
California

RECOMMENDATION:

Receive and file the Audit for the Long Beach Museum of Art (LBMA) Capital Campaign and request City Council to direct City Management to collaborate with the LBMA Foundation (Foundation) to develop a comprehensive strategy for the Foundation's repayment of the tax-exempt variable rate lease revenue bonds (Bonds). Advise the City Council and City Auditor as to progress and plans for implementation in 90 days, six months, and one year from the date of receipt and filing of this report.

DISCUSSION

In early 2007, current Foundation management informed the City that they were concerned about prior management of Capital Campaign funds. This communication ultimately resulted in our audit of the Foundation's Capital Campaign. The results of our audit are detailed in the attached report.

The Long Beach Museum of Art Foundation's (Foundation) Capital Campaign is the fundraising effort to finance its renovation and expansion project. To facilitate this expansion project, the Long Beach Bond Finance Authority issued \$3,060,000 in Bonds in 1999, with the understanding that the Foundation's Capital Campaign would raise sufficient funds to repay the Bonds before the September 1, 2009, maturity date.

The purpose of our audit was to assess the current financial status of the Foundation's Capital Campaign to determine the Foundation's ability to satisfy the required bond principal payment or the reasons for its inability to do so.

Based upon the results of the procedures performed, we determined the following:

- The Foundation currently has only \$388,000 of the required \$3,060,000 principal payment due to mature on September 1, 2009, and has no formal plan in place to obtain the balance of the required funds.
- The Foundation under-collected Capital Campaign contributions by at least \$1,084,000.
- The Foundation inappropriately spent \$1,588,000 of restricted Capital Campaign contributions on its daily business operations.

- The Foundation's Board of Trustees terminated both the former Executive Director and the Director of Finance during 2006. Several significant issues, including misappropriation of assets and conflicts of interest, regarding the Foundation's operations under its previous management came to our attention while performing the audit.

The City Auditor's Office appreciates current Foundation management and the Departments of Community Development and Financial Management for providing their time, information, and cooperation during the audit process. We welcome any questions the Council may have about this topic, and we look forward to presenting our inventory audit in the coming weeks.

TIMING CONSIDERATIONS

The bonds are due on September 1, 2009. Due to the fact that this deadline is only fourteen and a half months away, we recommend management of the City and the Foundation act swiftly to design a plan for repayment of the \$3.06 million bonds.

FISCAL IMPACT

The City's General Fund is obligated to pay the \$3.06 million bond debt, regardless of the Foundation's ability to reimburse the City. To the extent that the Foundation is able to repay the debt, that will directly offset the City's liability up to \$3.06 million.

SUGGESTED ACTION:

Approve recommendation.

Respectfully submitted,



LAURA L. DOUD, CPA
CITY AUDITOR

Attachment

**Long Beach Museum of Art
Capital Campaign
Audit Report**

June 2008



OFFICE OF THE CITY AUDITOR

**LAURA L. DOUD, CPA
CITY AUDITOR**

City of Long Beach, California

Office of the City Auditor

Audit Report

**Long Beach Museum of Art
Capital Campaign**

June 2008



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Executive Summary

We recently concluded our audit of the Long Beach Museum of Art Foundation's (Foundation) Capital Campaign, the Foundation's fundraising efforts to finance its renovation and expansion project. To facilitate this expansion project, the Long Beach Bond Finance Authority, a subsidiary of the City of Long Beach (City), issued \$3,060,000 in tax-exempt variable rate lease revenue bonds (Bonds), with the understanding that the Foundation's Capital Campaign would raise sufficient funds to repay the Bonds before the September 1, 2009 maturity date.

The purpose of our audit was to assess the current financial status of the Foundation's Capital Campaign to determine the Foundation's ability to satisfy the required bond principal payment or the reasons for its inability to do so.

While conducting fieldwork we became aware of serious issues such as misappropriation of assets, lack of oversight of internal controls, and conflict of interest that we believe contributed to the existing financial condition of the Capital Campaign. These issues are discussed in more detail within Issue #2 on page 3 of the Executive Summary and on page 13 of the body of the report.

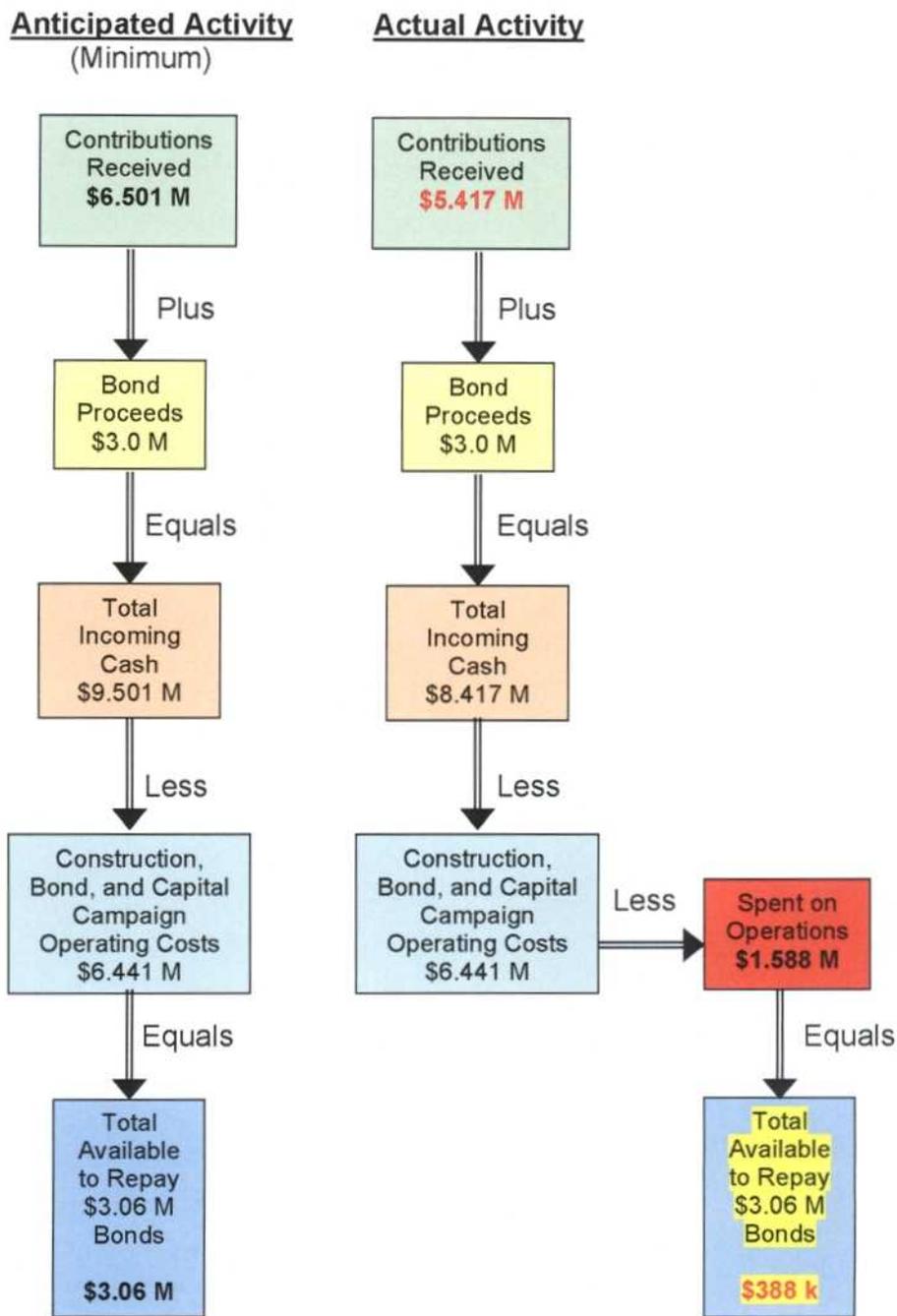
We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Issue #1 - The Foundation does not have sufficient funds to repay the \$3,060,000 Bonds and has no formal plan in place to repay them.

Although the City's General Fund secured the debt service payments and other costs pertaining to the Bonds, legal agreements between the City and the Foundation established the intent that those payments and costs would ultimately be borne by the Foundation. Over the course of ten years, the Foundation collected \$5,417,000 in restricted contributions for the Capital Campaign, \$1,084,000 less than the minimum amount required to finance construction, make bond payments, and operate the Capital Campaign.

In addition to the \$5,417,000 of contributions collected, the Foundation received proceeds (net of issuance costs) from the Bonds of \$3,000,000. These net bond proceeds together with contributions received, less construction and other related costs, resulted in a remaining cash balance of \$1,976,000 available to repay the Bonds. However, the Foundation currently has only \$388,000 available to repay the Bonds. The remaining \$1,588,000 was spent on the Foundation's daily business operations, rather than held in trust to redeem the Bonds.

Anticipated vs. Actual Cash Flow



Issue #2 – While assessing the financial status of the Foundation’s Capital Campaign, several concerns regarding the Foundation’s operations under its previous management came to our attention. We grouped these issues into three categories: misappropriation of assets, lack of administrative oversight over internal controls, and conflict of interest.

Certain issues came to our attention during our audit that we believe contributed to the existing financial condition of the Capital Campaign. Throughout the audit, it became apparent that appropriate oversight was not practiced during the Capital Campaign and that personal interests may have been promoted over the best interests of the Museum. Below is a brief summary of the significant issues that came to our attention:

Misappropriation of Assets

- Altered deposit slips and cash receipts schedules
- Use of business credit cards for personal purposes

Lack of Administrative Oversight Over Internal Controls

- Employee advances in violation of Foundation policy
- Lack of segregation of duties
- Circumvention of policy requiring dual signatures on checks

Conflict of Interest

- Lack of conflict of interest statements signed by management and Board, although such statements are required by the Foundation’s policies
- No documentation evidencing disclosure by the then-President of the Foundation’s Board of Trustees that the company owned by her spouse was contracted to perform a small portion of the expansion project construction
- Use of the Foundation’s resources to operate a second, unrelated nonprofit organization

Overall Recommendations

We recommend that management of the City and the Foundation collaborate to devise a comprehensive strategy for the Foundation’s payment of the \$3,060,000 Bonds, which are due to mature on September 1, 2009. Additionally, we recommend the Foundation perform a thorough investigation of the improprieties identified throughout the report, quantify the Foundation’s losses, and recover those moneys, if possible. We request that City and Foundation management advise the City Council and the City Auditor as to progress and plans for implementation of these recommendations in 90 days, six months, and one year from the date of the filing of this report.

Background

History of Museum

The Long Beach Municipal Art Center (Center) was established in 1950 as a municipal art facility owned and operated by the City of Long Beach (City). Seven years later, the Center was renamed the Long Beach Museum of Art (Museum), and it adopted the appropriate organizational structure to operate as a museum. In 1985, the City turned over operation of the Museum to a newly formed private group, the Long Beach Museum of Art Foundation (Foundation). The Foundation is a non-profit, public benefit corporation. In exchange for



Original Museum Building

the management and maintenance of the City's museum, the City provides a base level of support to the Foundation on an annual basis.

The annual contractual monetary support provided by the City to the Foundation for the last 5 years was as follows:

Foundation's Fiscal Year (FY)	Annual Support Provided to Foundation by City	Total Unrestricted Foundation Revenues (including City support)	% of Revenues Represented by City Support
2002	\$ 398,750	\$ 3,183,214	12.5%
2003	\$ 645,585	\$ 2,424,266	26.6%
2004	\$ 571,000	\$ 2,494,028	22.9%
2005	\$ 569,000	\$ 3,295,130	17.3%
2006	\$ 569,000	\$ 3,343,036	17.0%

History of Bonds

For several years, the Foundation explored options to expand the Museum. Ultimately, the Foundation concluded that its best option was to expand at the Museum's present, unique oceanfront site. The project plans included:

- Construction of a new 12,000 square foot museum building;
- Restoration and interior renovation of the existing main house, including a new café and museum shop;
- Relocation, interior renovation, and exterior restoration of the carriage house for use as an educational facility;
- A parking lot east of the Museum; and
- New landscaping to enhance the garden for ground rentals and summer concerts.

The total project budget was \$6,500,000. The Foundation had already established the Capital Campaign, its fundraising effort to finance the renovation and expansion project. However, the Foundation's fundraising efforts had not yet garnered sufficient funds to pay for the entire project. After reviewing several alternatives, the Foundation determined that its best available financing option was for the Long Beach Bond Finance Authority, a fully owned subsidiary of the City, to issue \$3,060,000 of tax-exempt variable rate lease revenue bonds (Bonds) to assist the Foundation in completing the project. By supporting the expansion of the museum, the City hoped to increase community interest and public access to its art collection, as well as increase the cultural visibility and stature of the Museum within the art community. As such, the Bonds were issued in 1999 and structured with a 10-year maturity (with 100% principal repayment in 2009).



New Café Patio and Fountain

Intent of Parties

The City agreed to use its General Fund to secure the debt on behalf of the Foundation. Thus, the City is responsible for paying the bonds, as this obligation is separate from the Foundation's responsibility to reimburse the City. However, under the Pledge and Agency Agreement (Pledge Agreement), the Foundation agreed to pay the City a portion of its contributions (Pledged Moneys) raised through its Capital Campaign, with the intent that those moneys would be sufficient to pay all Bond-related costs and redeem the Bonds.

This financial understanding was further documented in City Management's letter to the City Council recommending that the City Council approve the Bond issuance. That council letter, dated September 14, 1999 (Bond Council Letter), stated "the Foundation intends to reimburse the City for all of its costs through the receipt of pledges from its 5-year capital campaign." The letter further mentioned that the Foundation's goal was to redeem the Bonds within five years. Nonetheless, the longer, 10-year bond maturity was to allow the City and Foundation more flexibility should there be a need to extend the targeted redemption date.

Audit Objectives, Scope, and Methodology

In early 2007, current Foundation management informed City management that there may have been a misuse of Capital Campaign funds by the Foundation's previous management and that there were insufficient Capital Campaign funds to repay the Bonds due to mature in 2009. This communication ultimately resulted in our audit of the Foundation's Capital Campaign.



New Museum Building

The purpose of our audit was to assess the current financial status of the Foundation's Capital Campaign to determine the Foundation's ability to satisfy the required \$3,060,000 bond principal payment or the reasons for its inability to do so. The Foundation began collecting Capital Campaign contributions in FY 1996, and Capital Campaign activity continued throughout 2006. Therefore, the scope of the audit was defined as the period from October 1, 1995 through December 31, 2006.

In separate instances during 2006, the Foundation's Board of Trustees terminated both the former Executive Director and the former Director of Finance and Operations. Due to the alleged misuse of Capital Campaign funds reported by the Foundation's current management, lack of segregation of duties, lack of record retention, and lack of historical knowledge, we were unable to rely on the internally generated financial records of the Foundation. Through the procedures performed below, we compiled a comprehensive list of Capital Campaign contributions and established an overall cost of the expansion project, including construction, Bond, and Capital Campaign operating costs.

While conducting the audit, we used the following methodology and performed the following tasks:

- Reviewed all Governing Documents in order to gain an understanding of the transaction and responsibility of the parties involved. The Governing Documents are the Bond Official Statement, Trust Agreement, Lease Agreement, Sublease Agreement, and the Pledge and Agency Agreement.
- Reviewed the Agreement to Manage Art Collection between the City and the Foundation.
- Reviewed the Bond Council Letter in order to gain an understanding of the intent of the parties involved.
- Consulted the American Association of Museums' *Code of Ethics for Museums and Best Practices for U.S. Museums*.
- Reviewed the Foundation's Employment Policies.

- Reviewed the Foundation's audited Financial Statements for FY 1996 through FY 2006. Reviewed the Management Letters issued to Foundation management by the external auditors for FY 1999 through FY 2006. Reviewed Foundation's management responses to the Management Letters for FY 2004 and FY 2005.
- Conducted interviews with current Foundation management.
- Conducted interviews with Department of Community Development management.
- Obtained and reviewed Foundation board minutes for the period of November 1996 to February 2007.
- Reviewed the prior audit report issued by the Office of the City Auditor, dated February 7, 2006, and obtained an update from the Foundation and from City management with respect to prior audit recommendations, excluding all inventory-related recommendations. (To review follow-up of inventory recommendations, see the Long Beach Museum of Art **Inventory** audit report, dated July 2008.)
- Obtained and reviewed the Foundation's general ledger for FY 1999 – 2006.
- Obtained, reviewed, and scheduled individual and institutional donor records for 191 donors over the period of October 1, 1995 through December 31, 2006.
- Reviewed and scheduled all bank statement activity for the Foundation's 19 bank accounts for the period of October 1, 1995 through December 31, 2006.
- Obtained and reviewed detailed cash receipt records for the period of February 1, 2001 through December 31, 2006.
- Identified and scheduled changes to deposits and cash receipt schedules noted during our testwork.
- Obtained and reviewed donor letters requesting a total of \$787,000 in Capital Campaign contributions be temporarily unrestricted for operational support.
- Cross-referenced the Capital Campaign contribution records provided by the Foundation to the contributions identified through the detailed testwork performed during the audit.
- Confirmed net bond proceeds of \$3,000,000 were deposited into the Foundation's bank account.

- Reviewed disbursement activity to over 3,000 vendors for the period of October 1, 1995 through December 31, 2006.
- Identified construction-related third-party disbursements.
- Reviewed internal operating costs allocated to the Capital Campaign.
- Identified costs pertaining to the issuance of the Bonds, including current interest payments to the City.
- Grouped disbursements pertaining to the Foundation's daily business operations into 11 categories.
- Cross-referenced the cost of the construction, bond costs, and Capital Campaign operating costs provided by the Foundation to the cost identified through the detailed testwork performed during the audit.
- Calculated Capital Campaign contributions restricted for the repayment of debt, as defined by the Governing Documents.
- Consulted the Long Beach City Attorney's office for legal interpretation of Governing Documents.

Current Foundation management attests that they have provided us with full access to all documents they have for the Foundation, although donor records were incomplete, and cash receipt records prior to February 2001 and support for disbursements prior to 1999 were missing. However, we do not believe this missing and/or incomplete data poses a scope limitation, as we performed alternative procedures to obtain sufficient data to achieve our audit objectives.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Issues and Observations

Issue #1 - The Foundation currently has only \$388,000 of the \$3,060,000 needed in order to redeem the Bonds set to mature on September 1, 2009, and has no formal plan in place to obtain the balance of the required funds.

As stated above, both the City and the Foundation fully intended that the Foundation would bear 100% of the Bond costs, including the principal repayment. That intent was established in multiple documents, including the Pledge Agreement, which specified that the Foundation expected the total amount of Pledged Moneys received from its Capital Campaign to be sufficient to pay all Bond costs and redeem the Bonds. Although the Foundation's Capital Campaign has been completed, raising approximately \$5,417,000, the Foundation currently has only \$388,000 of the required \$3,060,000 available to repay the Bonds and has no formal plan in place to raise additional funds to repay the Bonds. Our audit work revealed that the Foundation's current lack of funds to repay the Bonds resulted from two main factors: 1) the Foundation did not collect sufficient donations; and 2) the Foundation inappropriately spent money restricted for the repayment of the Bonds on its daily business operations.

Insufficient Donations

The Foundation collected approximately \$1,084,000 less in donations than the minimum required to redeem the Bonds.

The Foundation's cash flow pertaining to the Capital Campaign and project construction was as follows:

Expansion Project Cash Flow Schedule

Capital Campaign contributions received	\$ 5,417,000
Net Bond proceeds received	<u>3,000,000</u>
Total cash inflow pertaining to project construction	8,417,000
Total cost of project construction and Capital Campaign, including all Bond-related costs and Capital Campaign operating expenses	<u>6,441,000</u>
Remaining cash balance that should have been available to redeem the Bonds***	1,976,000
Bond redemption amount	<u>3,060,000</u>
Donation deficit (minimum needed)	<u>\$(1,084,000)</u>

*** - See *Restricted Donations Spent On Operations* below

Misrepresentation to Board of Trustees and Donors

Throughout the audit, we identified instances of misrepresentation to the Foundation's Board of Trustees and/or donors regarding the amount of contributions collected. Significant examples of these misrepresentations are as follows:

- In the board meeting minutes of January 2001, the Capital Campaign Committee reported to the Board that the "Museum had reached its goal of \$6.5 million" in donations. However, as stated above, from October 1995 through December 2006, the Foundation collected only \$5,417,000, over a million dollars less than the amount reported to the Board in 2001.
- The Foundation documented in correspondence to donors that it had received a \$1 million in-kind gift of land from the City. In fact, in support of the Museum's expansion, the City leased a nearby City-owned lot to the Foundation free of charge. However, there was no legal conveyance of the lot, nor was there any intent for the City to donate the land to the Foundation.
- The Foundation included in its Capital Campaign revenue \$225,000 of contributions that were restricted for purposes other than the Capital Campaign.

Restricted Donations Spent On Operations

The Foundation inappropriately spent \$1,588,000 of contributions restricted for the repayment of the Bonds on its daily business operations.

The Expansion Project Cash Flow Schedule on page 9 identifies \$1,976,000 that the Foundation should have available to repay the Bonds. However, the Foundation currently has only \$388,000 restricted for Bond repayment. The Foundation spent the differential, \$1,588,000, on its daily business activities as evidenced by the following:

- The Foundation issued correspondence in October 2001 stating that it had used Capital Campaign funds to meet its cash flow challenges and that it was in the process of requesting temporary releases of the donation restrictions from the donors.
- The Foundation sent letters to donors requesting that donors temporarily unrestrict their initial Capital Campaign gifts, with the understanding that the funds would be restored to the Capital Campaign fund by June 2009, in order for the Foundation to repay its debt to the City. However, this practice of requesting donors to unrestrict donations was inappropriate and was not approved by the City. Additionally, the total amount of Capital Campaign funds released from restriction through letters received from donors was only \$787,000, less than half the amount of Capital Campaign funds spent on operations.

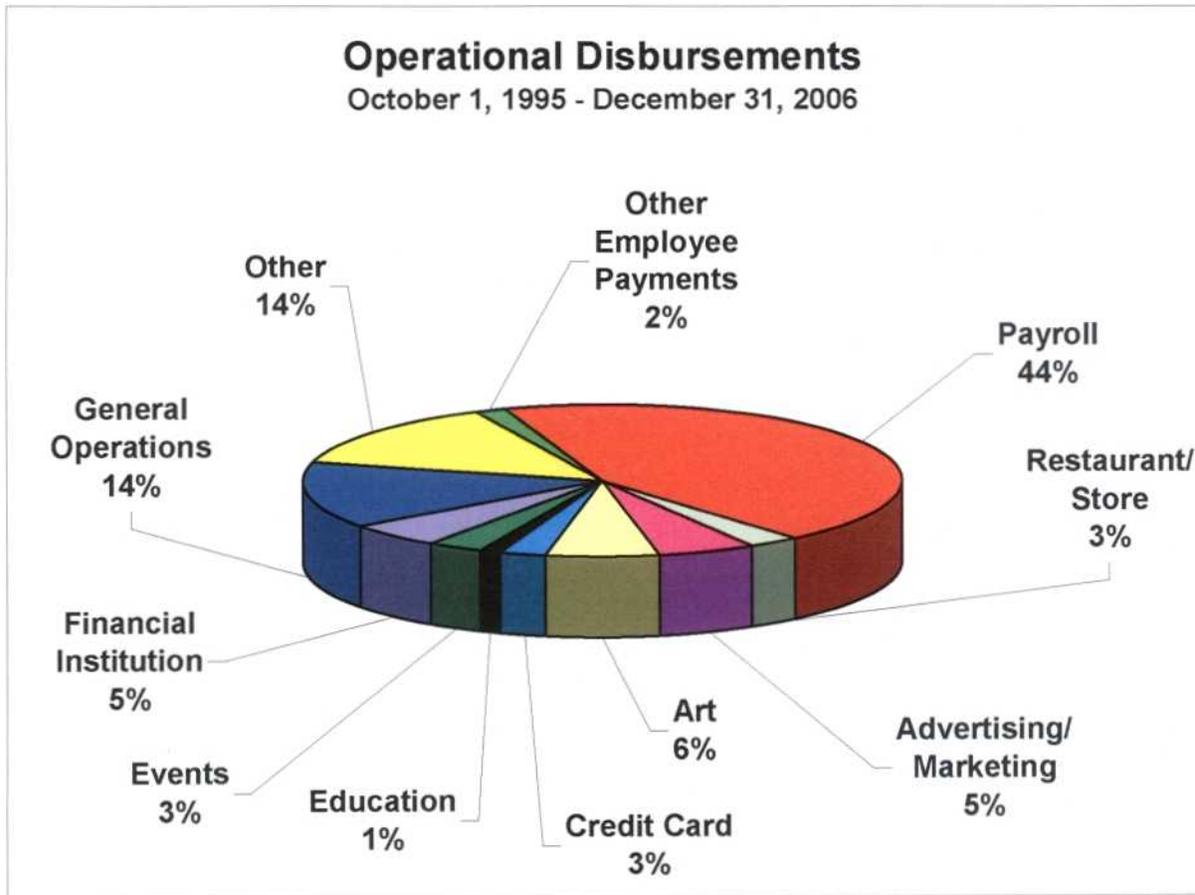
- The Foundation transferred funds from the restricted Capital Campaign bank account directly into its operating accounts. As such, funds specifically earmarked by donors for the Capital Campaign were commingled amongst operational funds in the Foundation's 19 bank accounts.

Although we have identified that \$1,588,000 was spent on the Foundation's daily business operations, because the restricted funds were commingled with the unrestricted funds, we were unable to determine specifically on what the \$1,588,000 was spent. We were only able to establish the entire population of the Foundation's expenditures for that time period.

Therefore, in order to determine how the \$1,588,000 may have been spent, we identified 100% of the Foundation's disbursements pertaining to its daily business operations from October 1, 1995 to December 31, 2006. We grouped the disbursements into the following 11 general categories:

- Payroll (including education, visitors' services, curatorial, exhibition, administrative, museum store and museum café staff)
- Other payments to employees
- General operations (utilities, sales tax, repairs, supplies, auditing fees, etc.)
- Art (acquisitions, exhibitions, conservation and research)
- Financial institutions
- Advertising/marketing
- Events
- Restaurant/store
- Credit cards
- Education (direct education costs)
- Other (Represents cumulative payments to payees less than \$10,000 and payments to third parties that were unable to be categorized)

The pie chart below represents the total disbursements of approximately \$25,200,000 pertaining to the Foundation's daily business operations as grouped into the 11 general categories listed above. Although we cannot establish exactly for what the \$1,588,000 was spent, the majority of the Foundation's daily operational expenditures was spent on Payroll (44%), Other (14%), and General Operations (14%). *Note: While the below chart reflects 1% of expenditures were spent on education, a portion of payroll expenditures also relate to educational activities.*



Issue #2 – While assessing the financial status of the Foundation’s Capital Campaign, several significant issues pertaining to the Foundation’s operations under its previous management came to our attention. We grouped the issues into three categories: misappropriation of assets, lack of administrative oversight over internal controls, and conflict of interest.

The main objective of our audit was to assess the financial status of the Capital Campaign. While conducting fieldwork, we identified serious issues that we believe contributed to the existing financial condition of the Capital Campaign and that require immediate investigation. We grouped the issues into three categories: misappropriation of assets, lack of administrative oversight over internal controls, and conflict of interest.

The American Association of Museums’ (AAM) *Code of Ethics for Museums* (AAM Code) states that a museum’s governing authority should protect and enhance the museum’s collections and programs and ensure all resources support the museum’s mission. Policies should be articulated, and prudent oversight should be practiced. The AAM Code further states that museum governance should represent the interests of society and should promote the public good, rather than individual financial gain.

We found that appropriate oversight was not practiced during the Capital Campaign, and, in some instances, it appears that personal interests were promoted over the best interests of the public. Additionally, we believe the deficiencies described below promoted an environment that impeded the Foundation’s ability to meet its obligation to the City with respect to the repayment of the Bonds.

Misappropriation of Assets

During our fieldwork, two issues came to our attention that meet the definition of asset misappropriation. Asset misappropriation is defined as the theft or misuse of an organization’s assets. Following is a summary of the two issues:

- *Altered cash receipt schedules and deposit slips* - While performing the procedures identified in the “Audit Objectives, Scope, and Methodology” section of this report, we identified changes to bank deposits and cash receipts schedules of \$33,400. In all cases, the cash deposit was reduced from the original deposit amount, often with no explanation given. In some instances, a handwritten note accompanied the altered deposit, indicating that the reason for the alteration was an advance to the former Director of Finance or to other employees. This issue was also identified by the Foundation’s external auditors in its FY 2005 letter to management on internal control weaknesses (Management Letter).

- *Use of Foundation's credit card for personal purposes* – The FY 2005 Management Letter from the external auditors stated that the former Director of Finance had used his company credit for personal use, in direct violation of the Foundation's credit card policy. He had used his company credit card to purchase airline tickets for family members, as well as pay for non-business hotel, restaurant, and clothing charges.

Lack of Administrative Oversight Over Internal Controls

The external auditors' FY 2005 Management Letter identified certain internal control deficiencies that may adversely affect the Foundation's ability to record, process, summarize, and report financial data in an accurate and efficient manner. Although we did not audit the Foundation's system of internal controls, we believe the issues identified by the external auditors adversely impacted the Foundation's ability to meet its financial obligation to the City. Therefore, we have summarized below certain significant internal control issues that were detailed in the external auditors' Management Letter:

- *Employee advances* – The external auditors identified numerous advances to employees, although the Foundation's policy clearly states that "absolutely no wage advances will be made to employees under any circumstances." In addition to the advances identified by the external auditors, while performing our fieldwork, we identified employee advances to numerous employees. Employee advances could be viewed as a diversion of assets that is not in the best interest of the Foundation or the City. Note: *current Foundation management represents that no employee advances have been made since current management has been in place.*
- *Segregation of duties* – There are key elements of segregation of duties that the Foundation could implement to improve existing internal controls without impairing efficiency. A lack of segregation of duties or adequate compensating controls increases the risk of theft of assets. Note: *current Foundation management represents that it has examined and revised procedures to improve internal controls.*
- *Dual signatures on checks* – In 2005, the Foundation's policy was that all checks in an amount of \$5,000 or greater required two signatures. While performing our fieldwork, we identified two instances where multiple checks with an aggregate total of \$5,000 or more were issued to the same payee on the same day. The external auditors also noted the circumvention of the dual-signature requirement in their FY 2005 Management Letter. Note: *In October 2006, the Foundation revised its policy to require all checks equal to or greater than \$2,500 to have two signatures, one from the Executive Director and one from the Board President, Treasurer, or Secretary.*

Conflict of Interest

The AAM Code states, “Where conflicts of interest arise – actual, potential, or perceived – the duty of loyalty to the museum and its mission must never be compromised.” Thus, a museum’s governing authority and staff must ensure that “no individual may use his or her position in a museum for personal gain or to benefit another at the expense of the museum, its mission, its reputation, and the society it serves.” The AAM Code further states that a museum should take reasonable steps to make its actions transparent and understandable to the public, especially where lack of transparency may reasonably lead to an appearance of a conflict of interest.

The Foundation’s Conflict of Interest Policy states, “The Museum desires to avoid situations in which actual or potential conflicts of interest may exist. To implement this objective, the Museum will attempt to avoid assignments that involve actual or potential conflicts of interest, as well as working relationships involving relatives or individuals with close personal relationships that may potentially lead to complaints of favoritism, lack of objectivity, or employee morale and dissension problems that can result from such relationships.”

However, we noted the following instances where there appears to be a conflict of interest:

- Although the Foundation’s Ethics Policy requires all staff and trustees to complete written conflict of interest statements, no such written statements were completed.
- The Foundation’s Board adopted a policy requiring potential conflicts of interest to be disclosed in writing. However, the Foundation was unable to locate any written documentation evidencing disclosure by the then-Board president that the construction company owned by her spouse was contracted to perform a small portion of construction on the Foundation’s expansion project.
- The then-Executive Director of the Foundation also served as the president of another non-profit organization. Foundation resources were used to operate the second organization at the Museum location. Further, the Museum’s address was listed as the second organization’s principal business address.

Recommendations

Current Audit Recommendations

The above discussion regarding the Foundation's internal control and other operational issues under its former management was to provide the reader with an understanding of the business environment in place during the Capital Campaign and detail circumstances that contributed to the current financial status of the Capital Campaign. However, we did not perform an internal control assessment of the Foundation's current environment. As such, we cannot and do not offer recommendations on internal control or other operational issues in this report.

The primary purpose of our audit was to ascertain the Foundation's ability to repay the Bonds or the reasons for its inability to do so. Therefore, we will limit our recommendation to that subject matter.

- #1 We recommend management of the City and the Foundation meet to devise a comprehensive strategy for re-payment of the \$3,060,000 Bonds, which are due to mature on September 1, 2009.
- #2 We recommend the current Foundation management complete a thorough investigation of the improprieties mentioned in this report, quantify the Foundation's losses, and recover those moneys, if possible. The Foundation should consider filing an insurance claim for its losses, if the losses are significant.
- #3 We request that City and Foundation management advise the City Council and the City Auditor as to progress and plans for implementation of the above recommendations in 90 days, six months, and one year from the date of the filing of this report.

Follow-Up to Prior Audit Recommendations

As a follow-up to the recommendations of the previous audit report dated February 7, 2006, excluding all inventory-related recommendations, we met with members of the City's Department of Community Development as well as the Foundation's management. All of the non-inventory related recommendations have been implemented with the significant exception of the recommendation that City management meet with Foundation management and devise a plan to resolve the shortage of Capital Campaign funds available for repayment of the Bonds. To review follow-up of those inventory recommendations, see the Long Beach Museum of Art **Inventory** Audit Report dated July 2008.

Appendix A

Management's Response

Long Beach Museum of Art Foundation

Long Beach Museum of Art

June 10, 2008

To: Laura L Doud, CPA, City Auditor

Foundation response to Audit Report, Long Beach Museum of Art Capital Campaign

Issue #1 – Foundation does not have sufficient funds to repay the \$3,060,000 Bonds and has no formal plan in place to repay them.

Foundation Response:

Although the Foundation currently does not have sufficient funds in place to repay the \$3,060,000 Bonds it is taking steps to ensure it will have the ability to meet its September 2009 deadline. The Foundation currently has \$388,000 in a restricted Capital Campaign account and is surveying all available options to procure the additional \$2,672,000 to meet the maturing Bond debt 16 months from this report.

The Foundation has met with City management for discussions of strategic planning. We concur with audit recommendations and Foundation will continue to meet with City management to report on strategy and funding status in 90 days, six months and one year from the date of filing of this audit report to keep the City current with the Foundation's progress.

Issue #2 – While assessing the financial status of the Foundation's Capital Campaign, several concerns regarding the Foundation's operations under its previous management came to our attention. We grouped these issues into three categories: theft of assets, lack of administrative oversight over internal controls, and conflict of interest.

Foundation Response:

Over the past 18 months the Foundation has taken numerous steps to create policies and procedures that have addressed the concerns of Museum management and those brought forward in the City Auditors Report. As a result I believe we are building a much improved institution. The results of our self examination have created challenges and opportunities for major alterations within the Museum and this audits results will help us continue to build a healthier Museum. With the assistance of new senior staff, outside business and non-profit consultants along with dynamic Board leadership a critical eye was turned to examine all internal policies and procedures. Proper oversight and internal controls were either examined or replaced and more importantly enforced with strict adherence. Local, State and National laws were examined to ensure complete compliance as the future health of the Museum was at stake. The Foundation's independent auditors were brought in to investigate any areas that appeared, or were vulnerable, to unusual and/or illegal activities. Regulations for daily reporting and deposits of cash, checks and credit cards were changed and

implemented. Procedures and checks and balances were designed and implemented to prevent, or detect, any opportunities for any degree of theft or fraud. Dual check signing procedures are strictly adhered too as well as adjusted signature limits being set in place. Business credit cards and expense accounts are strictly monitored.

Along with internal policies being reviewed it was apparent that information reported to the Foundation Board needed to be delivered in a transparent and open manner. Accounting procedures and reporting methods were examined and were brought to new standards. Monthly Board reports delivered information in a new and direct manner and were designed to allow Foundation Board members to view all financial data and operational information clearly and completely. The Foundations Executive Committee and Finance Committee have worked closely with senior management to vigilantly watch and maintain the 2006-07 and 2007-08 annual budgets. It should be noted that in the Museum's 2007 and 2008 budgets contain a restoration account item to begin to repay the "borrowed" Capital Campaign funds.

The Museum has revised and implemented a new and greatly expanded employee manual that clearly outlines the Museum's employment policies including addressing conflict of interest. A Code of Ethics Policy was revisited and each employee educated on the importance of transparency and ethical conduct. Anything less has not been tolerated. A core values statement was written and adopted by all staff. All payroll regulations are strictly adhered to and all past employee advances and loan debts have been satisfied. A Conflict of Interest Statement has been included in Trustee orientation materials but a separate standing policy has now been written and approved for all Foundation Trustees. The statements are signed and stored in each permanent file.

Over the past year the Museum has welcomed the City Auditors team of professionals. They have been an invaluable source for information and support during a critical time at the City's Art Museum. With the goals that have been accomplished over the past 18 months the Museum is very optimistic about the future. The Museum staff and Foundation Board look forward to continued success and working with the City with openness and transparency. We look forward to offering the highest level of quality artistic exhibitions, educational programming and cultural resources for the Citizens of Long Beach.

Sincerely and Respectfully,



Ronald C. Nelson
Director, Long Beach Museum of Art



Roberta Jenkins
President, Foundation Board

Appendix B

Management's Response

City of Long Beach



CITY OF LONG BEACH

333 WEST OCEAN BOULEVARD

LONG BEACH, CALIFORNIA 90802

(562) 570-6711 FAX (562) 570-6427

June 3, 2008

Laura Doud, City Auditor
333 West Ocean Boulevard
8th Floor
Long Beach, California 90802

Re: Management's Response – Long Beach Museum of Art Capital Campaign Audit Report

Dear Ms. Doud:

In Fiscal Year 2007, the City Manager requested that the City Auditor conduct an audit of the status of the Long Beach Museum of Art's Capital Campaign. This request was made after Foundation management informed the City of the misuse of Capital Campaign funds and that insufficient funds may not be available to repay the Bonds on September 1, 2009.

We would like to thank the City Auditor for the extensive work performed in this audit and the analysis regarding the overall results of the Capital Campaign. As there has been significant turnover in both Museum and City Management staff, the responses to these audit findings are largely prospective in nature and will describe the policies, procedures and internal controls that the City will implement to avoid the misappropriation of funds by a City subsidiary in the future, to the greatest extent possible.

Issue #1

The Foundation does not have sufficient funds to repay the \$3,060,000 bonds and has no formal plan in place to repay them.

Insufficient Donations: The Foundation collected approximately \$1,084,000 less in donations than required to redeem the Bonds.

Restricted Donations Spent on Operations: The Foundation spent \$1,588,000 of contributions restricted for the repayment of the Bonds on its daily business operations.

City Management Response:

Insufficient Funds

While the Foundation successfully raised \$5,417,000 in its Capital Campaign, this amount fell short of the required amount to repay the bonds by \$1,084,000. The Council letter authorizing the issuance of the bonds clearly assumed that the Foundation's Capital Campaign would raise sufficient funds to repay all of the debt service related to the Bonds, including the required \$3,060,000 balloon payment due on September 1, 2009, as well as, monthly interest payments.

The City will amend its Financial Policies and Procedures to require that if and when Capital Campaign funds raised by a subsidiary fall short of the amount required to fully pay debt obligations, that the City Manager be informed within 30 days of such a determination. In addition, it is further recommended that the subsidiary on whose behalf the debt was issued, submit a Corrective Action Plan within 90 days to the City Manager identifying the steps it will take to raise the additional funds required to ensure the timely payment of debt service.

Restricted Donations Spent on Operations

The City's financial policies and procedures strictly prohibit the use of restricted funds for purposes other than those specified. As such, the City objects to the Foundation's use of \$1,588,000 in Capital Campaign funds to support its daily business operations.

To avoid the misuse or reallocation of restricted funds for debt service in the future, the City will amend its Financial Policies and Procedures to require that all funds raised by a City subsidiary for the repayment of debt service issued by the City on its behalf, be deposited into a separate and discrete trust account from which funds can only be withdrawn with the written permission of the City, exclusively for the repayment of debt service. This will both avoid the commingling of restricted funds with the subsidiary's operating funds or bank accounts, and also ensure that restricted funds are set aside with a third party trustee solely for the repayment of debt service. As the City currently utilizes an independent trustee for many of its bond issuances, this is not administratively cumbersome. This recommendation will only apply to bonds issued by the City on behalf of a City subsidiary, which are backed by the General Fund. Sufficient internal controls are currently in place for segregating revenue to pay debt service on the City's other debt obligations.

Further, the Department of Financial Management and the Department of Community Development have held numerous meetings with the Foundation Board and Museum management over the last 180 days to develop a plan for repayment. We agree with the Auditor's recommendation to provide status updates in 90 days, six months and one year to ensure a timely solution is developed.

Issue #2

While assessing the financial status of the Foundation's Capital Campaign, several concerns regarding the Foundation's operations under its previous management came to our attention. We grouped these issues into three categories: misappropriation of assets, lack of administrative oversight over internal controls, and conflict of interest.

City Management Response:

Misappropriation of Assets

City Management will meet with the City Attorney, the City Prosecutor, the City Auditor and the Foundation Management to determine what steps may be taken to further investigate the allegations of the misappropriation of assets. We will provide a report to the City Council on the outcome of the meetings and any actions taken.

In addition, on an annual basis, the Department of Financial Management will extensively review the Foundation's audited financial statements to identify potential internal control weaknesses that could or may have already led to the misuse of assets. It is recommended that if the Foundation or any other City subsidiary refuse to provide complete annual audited financial statements (including

the essential "Notes to the Financial Statements") that it result in the application of fines or penalties, including withholding payments under the Operating Agreement. It is also recommended that future Agreements entered into between the City and a third party to operate a City-owned asset include the requirement that City management have full and complete access to audited financial reports and other critical financial information.

Lack of Administrative Oversight of Internal Controls

City Management is meeting with the Foundation Management to review what has been implemented to increase administrative oversight over internal controls. City Management has been assured that a number of procedures have been implemented over the last 18 months to improve the management of credits cards, cash management procedures, and a more stringent dual check signing procedure.

Conflict of Interest

It is important to note that the Foundation has developed a new employee training manual that includes a code of ethics, signed by each employee and maintained in their personnel files. City Management will work with the Foundation to ensure that Board members' files contain the same signed code of ethics documents.

The Audit raised one conflict of interest issue that City Management believes is overstated. The Audit states "the Foundation was unable to locate any written documentation evidencing disclosure by the then-Board President that the construction company owned by her spouse was contracted to perform a small portion of construction on the Foundation expansion project." The work performed was on the installation of a fountain for which no other bids were submitted. The value of the construction was approximately \$60,000, a very small part of the Foundation expansion project. The Foundation will ensure that any future construction contracts, no matter the value, will be fully documented.

City Management will investigate the other non-profit organizations using the Museum's address to determine what legal or corrective actions are necessary to resolve this finding. Foundation management has assured the City that it was operated by former employees and is not supported or related to the Foundation or its current staff.

Sincerely,



LORI ANN FARRELL
DIRECTOR OF FINANCIAL MANAGEMENT/CFO



DENNIS J. THYS
DIRECTOR OF COMMUNITY DEVELOPMENT

LAF:DT
LBMA Capital Campaign Audit Response.doc

CC: PATRICK H. WEST, CITY MANAGER
SUZANNE FRICK, ASSISTANT CITY MANAGER
REGINALD I. HARRISON, DEPUTY CITY MANAGER