



A REPORT
TO THE
ARIZONA LEGISLATURE

Special Investigative Unit

Special Investigation

Arizona Department of Emergency and Military Affairs

Theft and Misuse of Public Monies

February • 2012



Debra K. Davenport
Auditor General

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February 23, 2012

Members of the Arizona Legislature

The Honorable Janice K. Brewer, Governor

Major General Hugo E. Salazar, Adjutant General
Arizona Department of Emergency and Military Affairs

The Honorable Tom Horne
Office of the Attorney General

The Office of the Auditor General has conducted a special investigation of the Arizona Department of Emergency and Military Affairs for the period May 2003 through August 2011. The investigation determined the amount of public monies misused, if any, during that period and the extent to which those monies were misused.

The investigation consisted primarily of inquiries and examination of selected financial records and other documentation. Therefore, the investigation was substantially less in scope than an audit conducted in accordance with generally accepted auditing standards. Accordingly, the Office does not express an opinion on the adequacy of the financial records or the internal controls of the Arizona Department of Emergency and Military Affairs. The Office also does not ensure that all matters involving the Department's internal controls, which might be material weaknesses under standards established by the American Institute of Certified Public Accountants or other conditions that may require correction or improvement, have been disclosed.

The accompanying Investigative Report describes the Office's findings and recommendations as a result of this special investigation.

After this report is distributed to the members of the Arizona State Legislature, the Governor, the Adjutant General, and the Attorney General, it becomes public record.

Debbie Davenport
Auditor General

Attachment

SUMMARY

In August 2011, the Arizona Department of Emergency and Military Affairs (Department) requested that the Arizona Attorney General's Office investigate allegations of financial misconduct by James Burnes, the Department's former resources manager of state activities. After its investigation, the Attorney General's Office took criminal action against Mr. Burnes, resulting in his indictment on eight felony charges for his conduct from January 2007 through August 2011 (see the Conclusion on page 23 of this report).

The Office of the Auditor General became aware of these allegations and conducted an investigation to identify any deficiencies in the Department's internal control structure that contributed to the financial misconduct perpetrated by Mr. Burnes. Additionally, the investigation's objective was to identify the total monies missing from the Department and the total monies missing from a separate nonprofit corporation named the Arizona National Guard Emergency Relief Fund (AERF), for which Mr. Burnes was the comptroller. Our investigation examined department and AERF records dating back to 2002.

As a result of our investigation, we determined that from May 2003 through August 2011, Mr. Burnes embezzled monies totaling \$2,710,383 from the Department and AERF by withdrawing cash, issuing checks to himself, and transferring money into his personal account. Mr. Burnes then used these monies for his gambling and personal tax-related expenses. These monies were intended to support both the Department's responsibility of protecting Arizona's citizens and AERF's mission of providing emergency financial assistance to Arizona National Guard and other service members and their families.

Specifically, beginning in September 2005, more than 2 years after Mr. Burnes began embezzling monies from AERF, he embezzled and misused at least \$1,143,140 of department monies, including state and federal monies, and other revenues received by the Department. Mr. Burnes did so by taking possession of a \$500,000 department check before it could be deposited into a department account, and by improperly directing his subordinates to issue 12 department checks totaling \$643,140 to AERF. Mr. Burnes then unlawfully deposited the \$1,143,140 of embezzled department monies into AERF's bank accounts, which he also controlled.

Investigation Highlights

James Burnes, former Department of Emergency and Military Affairs Resources Manager for State Activities:

- Embezzled \$2,710,383 from the Department and AERF, using the money for his gambling and personal tax-related expenses
- Concealed his theft by creating false audit reports and financial records

However, from May 2003 to August 2011, Mr. Burnes embezzled a total of \$2,710,383 from the Department and AERF for his personal use. Because Mr. Burnes deposited the embezzled department monies into AERF bank accounts and commingled these public monies with AERF monies, auditors were unable to determine specifically how much of the embezzled AERF deposits originally came from the Department's monies and how much originated from AERF sources. Finally, in order to conceal his actions, Mr. Burnes created false documents including independent auditor's reports and financial activity records that he typically submitted to the AERF Board of Directors.

The Department's lack of internal controls, including inadequate oversight and lack of policies, allowed Mr. Burnes to misuse and embezzle department monies for nearly 6 years. In fact, a department official failed to take appropriate action when he was initially notified in February 2011 that Mr. Burnes improperly directed his subordinates to issue several department checks to AERF. Moreover, department officials gave AERF donated tax refund monies totaling \$471,714 to disburse to Arizona National Guard members' families. However, the Department should have directly managed and disbursed these monies to these members' families. Because of the Department's unlawful actions, it may have violated the gifting clause of the Arizona Constitution. Although no internal control system can totally prevent dishonest actions, there are measures the Department can take to help deter future instances of misconduct such as those Mr. Burnes perpetrated (see Recommendations on page 19 of this report).

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INTRODUCTION & BACKGROUND

Department of Emergency and Military Affairs

Established in 1972 pursuant to Arizona Revised Statutes (A.R.S.) §26-101, the Department of Emergency and Military Affairs (Department) is responsible for protecting and defending Arizona citizens' peace, health, safety, and quality of life. The Department has both emergency management and military responsibilities.

The Governor acts as the Department's commander-in-chief and appoints the Adjutant General, who serves as the Department's Director for a 5-year term. The Adjutant General must also meet federal guidelines to receive the appointment. The Adjutant General is responsible for ensuring adequate management of the Department, as prescribed by state laws and regulations. The Department is financially accountable to Arizona's citizens, in general, and to Arizona service members and their families, in particular, for the state and federal appropriations, donations, and other revenue it receives. The Department's fiscal year 2011 revenues totaled more than \$72 million (unaudited).

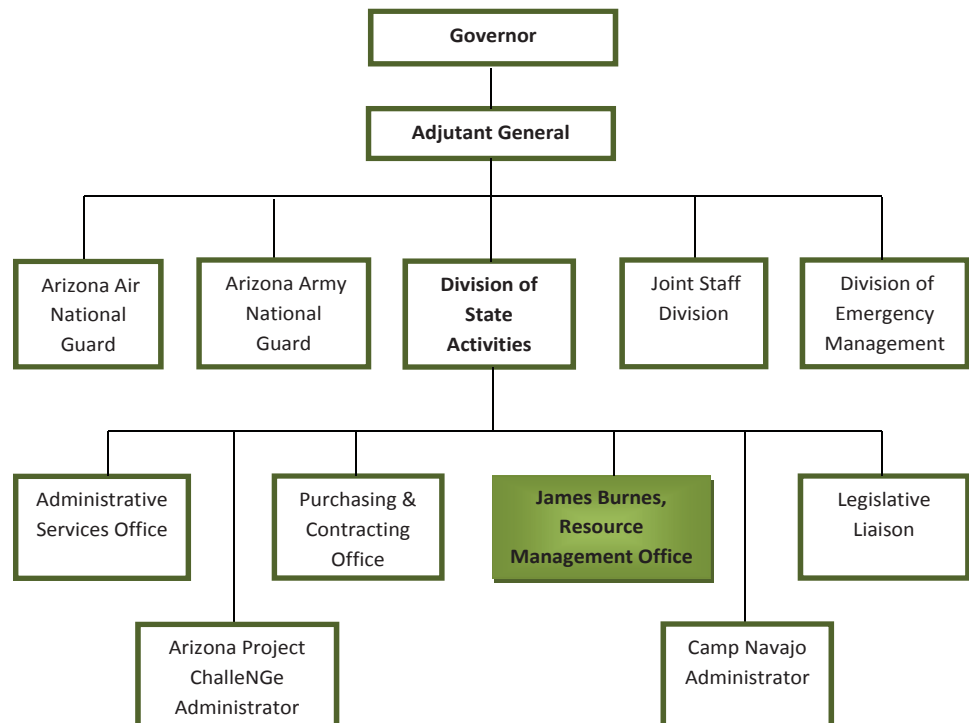
The Department has more than 530 employees and as shown in Figure 1 (see page 2) is composed of five divisions: Arizona Air National Guard, Arizona Army National Guard, Joint Staff Division, Division of Emergency Management, and lastly, the Division of State Activities. Specifically:

- **Arizona Air National Guard**—supports the activities of the approximately 2,500 men and women serving in the Air National Guard, which form Arizona's reserve component for the United States Air Force.
- **Arizona Army National Guard**—supports the activities of the approximately 5,200 men and women serving in the Army National Guard, which form Arizona's reserve component for the United States Army.
- **Joint Staff Division**—is responsible for creating a joint task force during a crisis response, and supervising the Arizona National Guard Counter-Drug Program, the Weapons of Mass Destruction Civil Support Team, and the State's partnership program with Kazakhstan. Additionally, the Joint Staff Division provides direct oversight for certain southwest border security operations.

- **Division of Emergency Management**—helps state, county, and local agencies prepare for and respond to disasters in an effort to reduce their impact on persons and property. It maintains the State Emergency Response and Recovery Plan, conducts emergency response and recovery exercises, and assists communities to obtain federal and state assistance.
- **Division of State Activities**—is responsible for the Department’s support functions including administrative services, purchasing and contracting, finance and accounting (resource management), a legislative liaison, Arizona Project ChalleNGe, and the Camp Navajo Industrial mission.

James Burnes was hired as the Department’s Resources Manager in June 2000, after retiring as a colonel from the Arizona Army National Guard. In this position, Mr. Burnes was responsible for the Department’s finance and accounting management activities. Specifically, Mr. Burnes managed state and federal monies; prepared budgets; oversaw cooperative agreements; supervised various staff members including accounting, property management, and grants coordinators; and served as the point of contact for various federal and state inspections, reviews, and audits. As discussed on page 4, the Department terminated Mr. Burnes’ employment on August 5, 2011.

Figure 1: Arizona Department of Emergency and Military Affairs Governing Structure



Source: Auditor General staff review of department information and interviews with department staff.

Arizona National Guard Emergency Relief Fund

The Arizona National Guard Emergency Relief Fund (AERF) is a private, nonprofit organization, which incorporated in the State of Arizona in June 1996 and is recognized by the Internal Revenue Service as a tax-exempt organization.¹ AERF's mission is to provide emergency financial assistance in the form of loans and grants to Arizona National Guard and other military service members² and their families. Typically, AERF provides loans and grants for recipients' rent, mortgage, food, utilities, transportation, vehicle repair, emergency travel, funeral, and medical expenses.

The Department does not control or manage AERF since it is a separate entity. However, since at least 2003, the Department and AERF have been closely aligned. In fact, AERF's mailing address is the same as the Department's. Additionally, several department and National Guard employees have simultaneously served AERF in some capacity, including as members of the Board of Directors, and as a board-appointed secretary and comptroller. From 2003 until his termination from the Department in 2011, Mr. Burnes functioned as AERF's comptroller. Mr. Burnes did not receive any additional compensation because he performed AERF duties during his normal working day, at the Department's expense.

As AERF's comptroller, Mr. Burnes had unmonitored access to AERF bank accounts because he could withdraw and transfer monies, sign AERF bank account checks, and make deposits without any oversight or approvals. Generally, Mr. Burnes made AERF account deposits, transfers, and withdrawals. In addition, Mr. Burnes received and reconciled bank statements, and compiled and reported financial activity to AERF's Board of Directors. Under Mr. Burnes or the Board of Directors, other department employees maintained AERF loan, grant, and donation information; generated and mailed donor and collection letters; received donations and repayments; prepared account deposits; and attended AERF board meetings and took minutes.

In addition to Mr. Burnes' department employment, he was also the comptroller for the Arizona National Guard Emergency Relief Fund, a closely aligned nonprofit corporation.

Mr. Burnes had unmonitored access to AERF bank accounts because he could withdraw and transfer monies, sign checks, and make deposits without any oversight or approvals.

Initial inquiry of James Burnes

In February 2011, a department official was informed by a subordinate that Mr. Burnes had improperly directed his subordinates to issue department checks to the AERF. The department checks were deposited into AERF's bank accounts, which Mr. Burnes had control over. However, the department official failed to take appropriate action and as a result, Mr. Burnes continued to direct his subordinates to issue department checks to AERF. Finally, in August 2011, after Mr. Burnes directed his subordinates to issue

¹ From 1996 until 2006, AERF was named the Army Reserve Components Emergency Relief Fund Foundation. In 2006, it changed its name to the Arizona National Guard Emergency Relief Fund. Other than this name change, AERF's function and purpose remained unchanged.

² AERF supports other military service members including those from the United States (U.S.) Army Reserve, U.S. Marine Corps Reserve, U.S. Navy Reserve, U.S. Air Force Reserve, and U.S. Coast Guard Reserve.

two more checks to AERF totaling \$140,000, the department official discussed the allegations with the Department's Adjutant General, who then directed the department official to contact the Arizona Attorney General's Office to investigate these allegations. Upon inquiry from the Attorney General's Office, Mr. Burnes admitted to transferring department monies to AERF. Mr. Burnes also admitted to taking money from AERF's bank accounts beginning in 2003 or 2004, and then using these monies to gamble and to pay his personal tax-related expenses. Consequently, the Department terminated Mr. Burnes' employment on August 5, 2011.

FINDING 1

Mr. Burnes embezzled department and AERF monies

From May 2003 to August 2011, James Burnes, former Department of Emergency and Military Affairs (Department) resources manager, embezzled at least \$2,710,383 of department and Arizona National Guard Emergency Relief Fund (AERF) monies by withdrawing cash, issuing checks to himself, and transferring monies into his personal account. Mr. Burnes then used these monies for his gambling and personal tax-related expenses. These monies were intended to support both the Department's responsibility of protecting Arizona's citizens and AERF's mission of providing emergency financial assistance to Arizona National Guard and other service members and their families.

Mr. Burnes embezzled \$2,710,383 in total from a combination of department and AERF monies. Specifically, Mr. Burnes:

- Embezzled and misused \$1,143,140 from department monies, including state and federal monies, and other revenues received by the Department. See the section titled "Sources of misused and embezzled department monies," on page 6.
- Deposited the \$1,143,140 of embezzled department monies into AERF bank accounts, thereby commingling these monies with AERF monies. It was improper for AERF to allow Mr. Burnes to deposit these embezzled department monies into AERF bank accounts, but because of Mr. Burnes' unmonitored access to AERF bank accounts, he was able to do so without any oversight or approvals.
- Embezzled \$2,710,383 in total from AERF. Because department and AERF monies were commingled, and only \$56,759 remained in AERF accounts when Mr. Burnes was terminated, auditors were unable to determine specifically how much of the embezzled AERF deposits originally came from the Department's monies, and how much originated from AERF sources. Therefore, the \$2,710,383 may include some or all of the embezzled department monies. See the sections titled "Sources of AERF deposits" and "Embezzlement schemes," on pages 9 and 10.

Sources of misused and embezzled department monies

From September 2005 to July 2011, Mr. Burnes embezzled and misused at least \$1,143,140 of the Department's public monies, including state and federal monies, and other revenues the Department received. Because of his position of authority, Mr. Burnes was able to divert and deposit department monies into two AERF bank accounts in two ways: 1) by misappropriating a \$500,000 check before it could be deposited with the Department and 2) by improperly directing his subordinates to issue 12 department checks totaling \$643,140 to AERF. Mr. Burnes then deposited these monies into AERF bank accounts and withdrew monies from these bank accounts for his personal use.

In addition, the Department unlawfully gave \$471,714 in donated tax refund monies to AERF. The Department did not have the authority to give these monies to AERF and it should have managed these monies directly and disbursed these monies to Arizona National Guard members' families. Unlike the \$1,143,140 of department monies that Mr. Burnes misappropriated, he was not responsible for the initial decision to give these monies to AERF, and therefore, this amount is excluded from Table 1 on page 8.

As a public official, Mr. Burnes had a responsibility to prudently manage money entrusted to him. However, by improperly directing and depositing public monies into AERF bank accounts, Mr. Burnes caused these monies to be used for unauthorized purposes; thereby misusing public monies. According to A.R.S. §35-301, it is a felony for a person to appropriate public money for his own use or for use by others, or, without legal authority, to deposit public money in a bank.

Misappropriated check—In September 2005, Mr. Burnes unlawfully deposited a \$500,000 title agency check payable to the Department's Arizona National Guard into one of AERF's bank accounts (see Table 1, page 8). The check was issued in connection with the sale of land adjacent to the Arizona National Guard's open firing range in Florence, Arizona. As part of the sale, the land seller requested that the Department erect a fence surrounding its firing range to protect the public. In return, it agreed to pay the Department \$500,000, which was intended to cover part or all of the associated expenses, including the cost of constructing the fence and any necessary environmental or archaeological surveys.

On September 26, 2005, this check, which the Department should have deposited to offset its costs in constructing the range fence, was hand-delivered to Mr. Burnes. However, Mr. Burnes misappropriated the check and deposited it the next day directly into one of AERF's bank accounts. Once deposited, Mr. Burnes withdrew monies from AERF's bank accounts for his personal use.

Although the fence was constructed, sufficient records were not available to determine the total cost or specific source of monies the Department used to build the fence.

Inappropriately authorized checks to AERF—From October 2007 to July 2011, Mr. Burnes inappropriately directed department staff to issue 12 checks totaling \$643,140 payable to AERF. Mr. Burnes circumvented the Department's disbursement policies, instructing employees to use certain department monies and to give the checks directly to him. He then deposited the checks into AERF's bank accounts and later withdrew monies from AERF's bank accounts for his personal use.

Specifically, Mr. Burnes directed department staff to issue checks from two department program areas:

- **Program Income Fund**—The Department established this fund in 1999 to deposit miscellaneous income earned by charging fees for various department programs. Mr. Burnes also improperly transferred state and federal grant monies into this fund, including state matching monies intended for several federal grants, and other unused grant monies that should have been returned to the federal government. Mr. Burnes was solely responsible for managing this fund, which enabled him to transfer monies into and out of this fund undetected. Once Mr. Burnes transferred enough money into this fund, he directed his staff to issue checks to AERF, which he then deposited and had immediate access to. Specifically, from October 2007 to August 2010, Mr. Burnes misappropriated \$363,140 by directing employees to issue seven checks from this fund to AERF (see Table 1, page 8).
- **Arizona Project Challenge**—This program, established in 1993, is one of the original 10 pilot programs created by the United States Department of Defense through the National Guard Bureau (NG). Arizona's Project Challenge is designed to help high-school dropouts improve their life skills, education levels, and employment potential. The Department administers this program with funding it receives from both state and federal monies. In fiscal year 2011, the Department spent \$1,628,818 in federal monies and \$1,023,765 in state matching and discretionary monies to fund Arizona's Project Challenge program. However, from September 2010 to July 2011, Mr. Burnes misappropriated \$280,000 of these monies by directing employees to issue five checks from Project Challenge to AERF (see Table 1, page 8).

Table 1: Misused & Embezzled Department Monies
September 2005 to July 2011

Year	Misappropriated Check	Program Income Fund	Project Challenge	Total
2005	\$500,000	\$0	\$0	\$500,000
2006	0	0	0	0
2007	0	100,000	0	100,000
2008	0	0	0	0
2009	0	194,588	0	194,588
2010	0	68,552	100,000	168,552
2011	0	0	180,000	180,000
Total	<u>\$500,000</u>	<u>\$363,140</u>	<u>\$280,000</u>	<u>\$1,143,140</u>

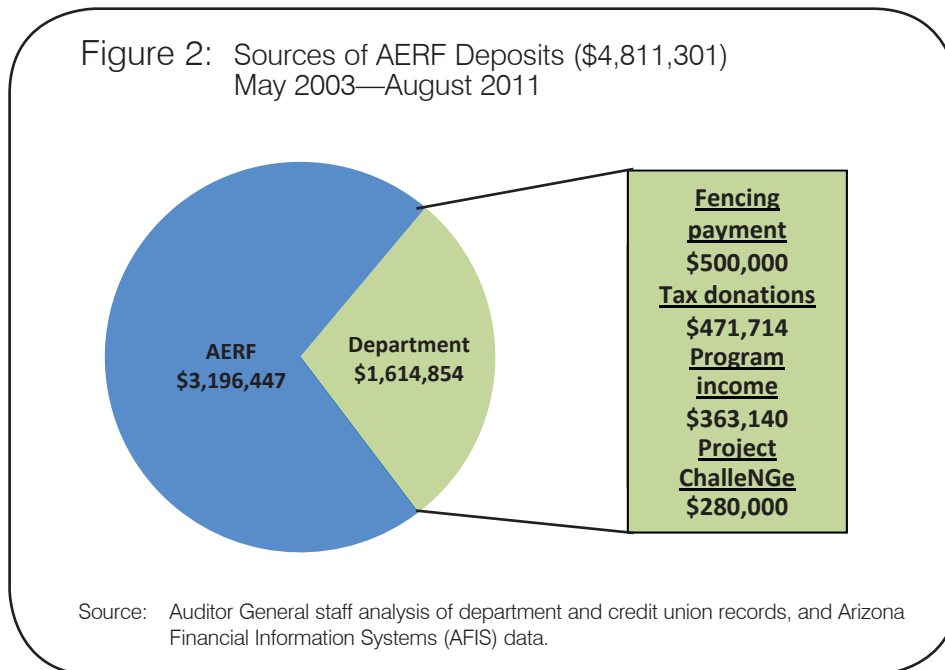
Source: Auditor General staff analysis of department and credit union records, and Arizona Financial Information Systems (AFIS) data.

Income tax refund donations—As described in Finding 4 on page 15, in 2005, the Arizona Legislature established the National Guard Relief Fund (relief fund), which is composed of monies donated by Arizona taxpayers through their tax returns to provide financial aid to families of Arizona National Guard members when the member is mobilized in support of a contingency (military) operation or a state emergency. The Department should have managed these monies directly and disbursed these monies directly to Arizona National Guard members' families. However, separate and apart from Mr. Burnes' misappropriations, the Department unlawfully gave to AERF these tax refund donations totaling \$471,714. Unlike the \$1,143,140 of department monies that Mr. Burnes misappropriated, he was not responsible for the initial decision to give these monies to AERF. By giving these tax relief fund monies to AERF, the Department relinquished its responsibilities for and control over how AERF used these public monies. As a result, after these monies were deposited into AERF's bank accounts and commingled with other AERF monies, Mr. Burnes withdrew monies from AERF bank accounts for his personal use.

Sources of AERF deposits

AERF received monies from several sources for its operations, in addition to department monies Mr. Burnes embezzled and deposited into AERF accounts. As illustrated in Figure 2, from May 2003 to August 2011, AERF deposits totaled \$4,811,301:

- Monies from normal AERF operation: \$3,196,447
 - Donations from individuals, corporations, and programs such as United Way, State Employees Charitable Campaign, and Combined Federal Campaign
 - Service members repaying loans that provided them with emergency financial assistance
 - Interest and dividend income
- Monies from the Department: \$1,614,854
 - Monies totaling \$1,143,140 misused and embezzled by Mr. Burnes as described in Table 1 on page 8.
 - Income tax refund donations totaling \$471,714, as described on page 8 and in Finding 4 on page 15.



As shown in Table 2, Mr. Burnes perpetrated fraudulent schemes to steal \$2,710,383, over half of the money deposited in AERF accounts during that period, for his personal expenses related to gambling and income taxes. Because the monies shown in Figure 2 were commingled, and only \$56,759 remained in AERF accounts when Mr. Burnes was terminated, auditors were unable to determine specifically how much of the embezzled AERF deposits originally came from the Department's monies, and how much originated from AERF sources.

Embezzlement schemes

During the time period May 2003 to August 2011, Mr. Burnes embezzled monies from AERF accounts totaling \$2,710,383 in four different ways:

- **Withdrawing cash:** On 675 occasions, Mr. Burnes withdrew cash totaling \$1,929,779 in amounts ranging from \$200 to \$5,000. Mr. Burnes visited the bank often, withdrawing cash up to 20 times in 1 month.
- **Writing checks payable to himself:** On at least 169 occasions, Mr. Burnes wrote and signed checks payable to himself totaling \$403,605. The checks ranged in amount from \$400 to \$5,000.
- **Issuing cashier's checks to himself:** On 32 occasions, Mr. Burnes issued cashier's checks to himself totaling \$336,999 and deposited them into his personal bank account. These checks were for amounts ranging from \$3,000 to \$40,000.
- **Electronic transfer:** In July 2011, Mr. Burnes electronically transferred \$40,000 into his personal bank account.

Table 2: Embezzlement of Department and AERF Monies
May 2003 to August 2011

<u>Theft</u>	<u>Amount</u>
Cash withdrawals	\$1,929,779
Checks written to self	403,605
Cashier's checks issued to self	336,999
Electronic transfer	40,000
Total	\$2,710,383

Source: Auditor General staff analysis of AERF's credit union records.

FINDING 2

Mr. Burnes falsified documents to conceal his improper actions

From 2005 to 2011, Mr. Burnes concealed his thefts from the Arizona National Guard Emergency Relief Fund (AERF) by creating various false documents including independent auditor's reports and financial activity records. Mr. Burnes presented these documents during AERF Board of Directors (Board) meetings, falsely purporting the information as true and the account balances accurate. Mr. Burnes also admitted to submitting some of these documents to the Internal Revenue Service.

Mr. Burnes falsified five independent auditor's reports dating back to at least 2005. Specifically, Mr. Burnes stated that he took an original audit report from a Certified Public Accounting firm, copied or retyped it, changed the dates, and signed it as the firm's representative. As an example, on March 11, 2010, Mr. Burnes created and forged an independent auditor's report that read in part, "In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Arizona National Guard Emergency Relief Fund [AERF] as of December 30, 2009..." The firm's representative stated that the firm had never performed an audit for AERF, the report signature was not his, and the logo Mr. Burnes used for the audit report letterhead was most likely taken from the firm's business card.

Mr. Burnes concealed his thefts by creating at least five false independent auditor's reports and six financial activity records, which he typically submitted to AERF board members.

Additionally, at the beginning of each year, Mr. Burnes provided the Board with a summary of the prior year's financial activity. From 2006 through 2011, Mr. Burnes falsified six separate financial activity records to conceal his improper actions. For example, during a January 26, 2010, AERF board meeting, Mr. Burnes stated that AERF bank account balances totaled \$586,989. However, AERF bank accounts actually totaled only \$18,883, a \$568,106 difference.

FINDING 3

A department official failed to prevent further misappropriations

Although a Department of Emergency and Military Affairs (Department) official was notified in February 2011 that Mr. Burnes had misappropriated department monies by directing department employees to make several improper disbursements of Project ChalleNGe monies, the official failed to take appropriate action, which allowed Mr. Burnes to embezzle additional monies until he was finally terminated in August 2011.

In January 2011, a department employee discovered that Mr. Burnes had improperly directed employees to disburse Project ChalleNGe monies to the Arizona National Guard Emergency Relief Fund (AERF). The employee initially approached Mr. Burnes, her supervisor, requesting that he reimburse Project ChalleNGe for the total she believed it was owed. Mr. Burnes failed to reimburse the program and in February 2011, the employee escalated her concerns to Mr. Burnes' supervisor, the State Activities Director (Director). The employee provided documents to the Director showing that from September 2010 to January 2011, Mr. Burnes had improperly directed \$140,000 of Project ChalleNGe money to AERF.

Although the Director knew, or should have known, that it was inappropriate to give Project ChalleNGe monies to AERF, he failed to take any action to determine whether the employee's concerns were valid. As a result, Mr. Burnes continued to direct employees to disburse Project ChalleNGe monies to AERF. In fact, on April 8 and July 12, 2011, Mr. Burnes instructed other department employees to issue two checks totaling an additional \$140,000 to AERF. These employees issued the checks and then notified the Director that Mr. Burnes had yet again diverted Project ChalleNGe monies to AERF.

Finally, after more than 5 months of inaction, the Director questioned Mr. Burnes about his actions and contacted an AERF board member to seek a review of AERF bank account records. Later, the AERF Board member determined that there had been multiple, unexplained cash withdrawals and transfers made from its bank accounts, which Mr. Burnes had unmonitored access to. The Director discussed the allegations with the Department's Adjutant General, who then directed him to contact the Arizona

Because a department official failed to promptly investigate an employee's concerns, Mr. Burnes was able to embezzle and misuse an additional \$140,000 from the Department.

Attorney General's Office. Four days later, the Adjutant General terminated Mr. Burnes' employment and more than 1 month later, the Director resigned from his position, in lieu of termination.

FINDING 4

Department officials failed to properly administer the National Guard Relief Fund

In 2005, the Arizona Legislature established the National Guard Relief Fund (relief fund), which is composed of monies donated by Arizona taxpayers through their tax returns to provide financial aid to families of Arizona National Guard members when the member is mobilized in support of a contingency (military) operation or a state emergency. In lieu of creating a separate entity to administer the relief fund, the Legislature specifically directed the Department of Emergency and Military Affairs' (Department) Adjutant General to manage it.

The Department received \$472,633 from Arizona taxpayers, which it should have disbursed to the families of National Guard service members. Instead, it gave \$471,714 to AERF.

Separate and apart from Mr. Burnes' misappropriations, from October 2007 to June 2011, the Department received \$472,633 from Arizona taxpayers, which it should have directly managed and disbursed to Arizona National Guard members' families. Instead, the Department gave nearly all of these monies, totaling \$471,714, to the private, nonprofit corporation Arizona National Guard Emergency Relief Fund (AERF) to disburse. The Arizona Constitution prohibits gifting of public monies, including donating or loaning public money to private individuals or organizations. The Department could not provide evidence that it sought legal advice, or otherwise discussed with its legal representative, the appropriateness of giving the relief fund monies to AERF.

The Arizona Constitution, Article IX, Section 7, states: "neither the State, nor any county, city, town, municipality, or other subdivision of the State shall ever give or loan its credit in the aid of, or make any donation or grant, by subsidy or otherwise, to any individual, association, or corporation, or become a joint owner with any person, company, or corporation, except as to such ownerships as may accrue to the State by operation of provision or law."

By giving the monies to AERF, the Department relinquished its responsibilities for and control over how AERF used these public monies. Once AERF received the relief fund monies, it then disbursed the monies according to its own will. In fact, AERF's mission is to provide emergency financial assistance in the form of loans and grants to not only Arizona National Guard family members, but also to National Guard members themselves, and other service members and their families. AERF maintained one account for monies received and disbursed to service members and

Attorney General Opinion I85-051 states in part: "While public funds may not be loaned or given to private individuals or entities, an incidental private benefit is not prohibited by Article IX as long as there is a public purpose served by the expenditure or loan of funds and the value to be received by the public is not far exceeded by the consideration being paid."

one account for monies received and disbursed to these groups' family members. However, because of Mr. Burnes' control over these two accounts, he was able to deposit the relief fund monies into both accounts, and then continuously transfer these monies between accounts, thereby commingling these monies with other AERF monies. AERF may have provided a portion of the Department's relief fund monies to National Guard members' families through loans and grants, but because relief fund monies were not accounted for separately, AERF may have also used the relief fund monies for items unrelated to the monies' authorized purposes. Specifically, AERF awarded loans and grants to Arizona National Guard members themselves, and to members and members' families of other service branches including the United States Army Reserve and United States Marine Corps Reserves. For example, in December 2007 and January 2008, AERF granted over \$30,000 to National Guard members to pay for the cost of their airfare home for the holidays. Further, as discussed in Finding 1 (see page 5), Mr. Burnes may have withdrawn some or all of the relief fund monies to use for his personal purposes.

Public officials with oversight authority have a responsibility to prudently manage money entrusted to them and to ensure that sufficient internal controls are designed and implemented to protect those monies. However, by giving relief fund monies to AERF, the Department effectively shifted its responsibilities for these public monies to AERF and it failed to safeguard and ensure that these monies were used solely for the National Guard members' families, as the Legislature and taxpayers had intended. Additionally, AERF is not subject to the laws and regulations imposed on state agencies, it is not restricted to using these monies for the specific purposes for which taxpayers initially donated them, and it does not have to comply with the state rules providing for the protection of public monies. Because of the Department's failure to properly administer the relief fund and AERF's failure to properly safeguard these monies, Mr. Burnes was able to embezzle monies from the Department and AERF, which may have included some or all of the relief fund monies after they were transferred from the Department to AERF.

The Department continues to receive relief fund monies donated by Arizona taxpayers; however, after September 2011, the Department discontinued its practice of giving these monies to AERF.

FINDING 5

Department officials failed to establish and maintain adequate controls

Public officials with oversight authority are responsible for ensuring that sufficient internal controls are designed and implemented to protect public monies. At a minimum, an internal control environment should allow management or employees, in the normal course of performing their assigned functions, to prevent or detect errors and fraudulent activity on a timely basis. Although Mr. Burnes overrode certain existing controls at the Department of Emergency and Military Affairs (Department) to perpetuate his actions, department officials also failed to exercise an appropriate level of oversight over Mr. Burnes' activities. Additionally, the Department failed to implement an adequate system of internal controls for disbursing department monies. In fact, the Department's insufficient monitoring and lack of policies weakened its control environment and allowed Mr. Burnes to embezzle and misuse public monies without being detected for nearly 6 years.

Contrary to the Department's standard, yet unwritten, process, Mr. Burnes was able to instruct his staff to issue payments to AERF without any additional supervisory approval and without providing any supporting documentation such as a receipt or invoice. If the Department had required Mr. Burnes' supervisor to review and approve his disbursement requests, it could have prevented Mr. Burnes from diverting monies from unauthorized sources, including federal and state monies, to the Arizona National Guard Emergency Relief Fund (AERF), and, consequently, from AERF to himself. The Department should determine the source of Mr. Burnes' misused and embezzled monies and then reimburse those sources accordingly. Additionally, the Department should establish formal, written policies and procedures outlining the approval process for all disbursement requests, including those requests made by management-level employees, and it should also provide training to educate department employees about this process.

Also, as discussed in Finding 4 (see page 15), the Department allowed its employees to improperly give relief fund monies to AERF. In doing so, the Department created a deficiency in its internal control structure, thereby allowing Mr. Burnes to freely circumvent proper disbursement procedures when issuing checks to AERF. The Department discontinued its practice of giving relief fund monies to AERF, and the Department should not give these monies to any other external entity or person to disburse on its behalf.

In addition, the Department failed to implement controls over its Program Income Fund. Unlike other department programs, this fund did not have a program manager, thus allowing Mr. Burnes to authorize transfers to and from this fund undetected. As a result, Mr. Burnes improperly disbursed to AERF state matching monies that were intended for other grants, and unused grant monies that should have been remitted to the federal government.

Further, department monies could be misappropriated because the Department does not have a policy that restricts employees from receiving vendor checks drawn on department accounts. Typically, department checks are mailed to vendors; however, Mr. Burnes instructed his employees to deliver the department checks directly to him. He then deposited the checks into AERF's bank accounts and withdrew monies from these bank accounts for his personal use. The Department should establish policies restricting employees from withholding vendor checks from the mail.

Finally, the Department failed to establish a formal process for reporting employee misconduct. The Department should create formal, written policies and procedures for reporting employee misconduct and it should provide training to educate department employees about these policies and procedures.

Recommendations

There are additional actions the Department could have taken and should take now that may further help to deter future misconduct like Mr. Burnes'. To help ensure the proper use of public monies, the Department should establish effective controls over department disbursements including policies, procedures, and monitoring activities. Specifically, department officials should:

1. Institute policies and procedures that provide effective oversight over management and address the risk of management override. For example, department officials should strengthen their understanding of the business and control climates, brainstorm potential fraud risks within the Department, cultivate a strong whistleblower system, and consistently maintain an appropriate level of objectivity and skepticism. In doing so, the Department increases the likelihood of preventing, deterring, and detecting fraudulent activity.
2. Create formal, written policies and procedures governing the Department's disbursement request process, including those requests made by management-level employees. These policies should outline the process for requesting, approving, and disbursing department monies. Additionally, for any requests made by management-level employees, the Department should outline the process for supervisory oversight and review. Finally, the Department should provide training and educate its employees about this process.
3. Ensure that expenditures are processed based on proper documentation. Such documentation includes, but is not limited to, properly and timely approved purchase orders, vendor invoices, vendor contracts, and claims requests. Additionally, the Department's normal practice is to mail vendor checks and therefore, the Department should establish formal, written policies and procedures restricting employees from withholding vendor checks from the mail.
4. Ensure the proper use and control of monies entrusted to them, including those monies deposited into the Department's National Guard Relief Fund. The Department continues to receive relief fund monies donated by Arizona taxpayers and after September 2011, the Department discontinued its practice of giving these monies to AERF. Additionally, the Department should not give these monies to any other external entity or person to disburse on its behalf. Instead the Department should directly manage and disburse these monies according to state laws, including A.R.S. §26-183 and the statutory requirements

for grant solicitation and awards established in A.R.S. §41-2701 et seq. Specifically, the Department should:

- a. Establish a formal grant process—Consistent with A.R.S. §41-2701 et seq, the Department should develop and implement a formal grant process to distribute relief fund monies for the benefit of Arizona National Guard family members as outlined under A.R.S. §26-183. This strengthened process, which should be followed for all relief fund expenditures, should address and include all statutory requirements for grant solicitation and awards. Elements of this grant process should include the following
 - o A request for a grant application that includes: (1) a description of the nature of the grant project, including the funding source and total amount of available monies; (2) the criteria or factors under which applications will be evaluated and the relative importance of each criteria or factor; and (3) the due date for application submittal and the anticipated time the awards may be made;
 - o A public notice of the request for grant applications at least 6 weeks before the application due date, and a requirement to publicly receive grant applications at the time and place designated in the request; and
 - o A requirement that applications be reviewed by at least three evaluators, based solely on the evaluation criteria or factors set forth in the request for grant applications. Specifically, the evaluators should make written recommendations regarding awards to the Department's Adjutant General, who may affirm, modify, or reject these recommendations. If the Adjutant General does not affirm the evaluators' recommendations, he should provide a written explanation for this decision.
5. Ensure the proper use and control of public monies including state and federal monies, by properly monitoring program activities to ensure required policies and procedures are consistently followed. Additionally, the Department should strengthen its controls over its Program Income Fund by assigning an employee and a supervisor to manage the fund. The Department should segregate the following employee duties: requesting disbursements, authorizing expenditures, performing monthly reconciliations of revenue and expenditure documents, and reporting monthly financial activity to management.

6. Determine the source, if possible, of Mr. Burnes' misused and embezzled monies, whether it is from federal or state matching monies, and then reimburse those sources accordingly.

7. Establish formal, written policies and procedures governing internal employee investigations to ensure that employee misconduct complaints are properly investigated and documented. These written policies and procedures should include the following information: assigning the parties responsible for managing the initial complaint, maintaining appropriate documentation, conducting interviews, and preparing a final conclusion report; instituting a general response time frame; and outlining the process for employees to submit formal complaints.

Conclusion

Arizona citizens, in general, and Arizona service members and their families, in particular, were deprived of proper and prudent management of public monies by the former Arizona Department of Emergency and Military Affairs Resources Manager, James Burnes, who misused and embezzled monies from the Arizona Department of Emergency and Military Affairs and the Arizona National Guard Emergency Relief Fund (AERF), a nonprofit corporation for which he acted as comptroller.

As a result, on October 19, 2011, the Arizona Attorney General's Office took criminal action against Mr. Burnes through the State Grand Jury. This action resulted in the indictment of Mr. Burnes on eight felony counts related to theft, fraudulent schemes, and forgery for the time period of January 1, 2007 through August 24, 2011.

Further, on February 15, 2012, as part of a plea agreement, Mr. Burnes pled guilty to two felony counts related to theft and fraudulent schemes. In addition, Mr. Burnes agreed to serve a term in the Arizona Department of Corrections, which will be determined by the Maricopa County Superior Court during sentencing procedures. Finally, Mr. Burnes was ordered to repay \$2,095,325 in total restitution to the Department and the AERF.