OLA

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Financial-Related Audit

Iron Range Resources and Rehabilitation Agency

July 1, 1998, through June 30, 2001

OCTOBER 31, 2002 **02-66**

Financial Audit Division

The Office of the Legislative Auditor (OLA) is a professional, nonpartisan office in the legislative branch of Minnesota State government. Its principal responsibility is to audit and evaluate the agencies and programs of state government (the State Auditor audits local governments).

OLA's Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division also investigates allegations that state resources have been used inappropriately.

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- Promote Accountability,
- Strengthen Legislative Oversight, and
- Support Good Financial Management.

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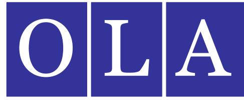

OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

Senator Ann H. Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Senator David Tomassoni, Chairman
Iron Range Resources and Rehabilitation Board

Members of the Iron Range Resources and Rehabilitation Board

Mr. John Swift, Commissioner
Iron Range Resources and Rehabilitation Agency

We have audited the Iron Range Resources and Rehabilitation Agency for the period July 1, 1998, through June 30, 2001. Our audit scope included: financial management, the Northeast Minnesota Economic Protection Trust Fund, the Taconite Area Environmental Protection Fund loans, grants, Giants Ridge Golf & Ski Resort, Ironworld Discovery Center, payroll, and other operating expenditures. The audit objectives and conclusions are highlighted in the individual chapters of this report.

We conducted our audit in accordance with *Government Auditing Standards*, as issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of management controls relevant to the audit. The standards also require that we design the audit to provide reasonable assurance that the Iron Range Resources and Rehabilitation Agency complied with provisions of laws, regulations, contracts, and grants that are significant to the audit. The management of the Iron Range Resources and Rehabilitation Agency and the Iron Range Resources and Rehabilitation Board are responsible for establishing and maintaining the internal control structure and complying with applicable laws, regulations, contracts, and grants.

This report is intended for the information of the Legislative Audit Commission, management of the Iron Range Resources and Rehabilitation Agency, and members of the Iron Range Resources and Rehabilitation Board. This restriction is not intended to limit the distribution of this report, which was released as a public document on October 31, 2002.

/s/ James R. Nobles	*/s/ Claudia J. Gudvangen*
James R. Nobles Legislative Auditor	Claudia J. Gudvangen, CPA Deputy Legislative Auditor

End of Fieldwork: May 24, 2002

Report Signed On: October 23, 2002

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Audit Participation

The following members of the Office of the Legislative Auditor prepared this report:

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Irene Hass	Auditor

Exit Conference

We discussed the results of the audit with the following staff of the Iron Range Resources and Rehabilitation Board and Agency at an exit conference on September 24, 2002:

David Tomassoni	Board Chair
John Swift	Commissioner
Brian Hiti	Deputy Commissioner
Don Dicklich	Chief Financial Officer

Iron Range Resources and Rehabilitation Agency

Report Summary

Key Findings and Recommendations

Statutory provisions do not clearly define the respective authorities of the board and the agency. We recommended that the board and the agency seek legislative clarification to define those actions that the agency can initiate without specific board approval.

The agency does not have a conflict of interest policy that addresses the unique conflicts that its employees and board may face. The sensitive nature of the agency's operations warrants a conflict of interest policy tailored to its environment. We recommended that the agency and the board design conflict of interest policies that recognize their unique roles in the community and the impact that actual or suspected preferential treatment may have to its reputation and integrity.

The agency's transactions with a venture capital fund may not have been an authorized use of the Northeast Minnesota Economic Protection Trust Fund. Since 1996, the agency gave the venture capital fund $2.25 million. The agency also did not adequately monitor the venture capital fund's use of the funds nor curtail certain financial activity that did not comply with the financing agreement or statutes. We recommended that the agency only use Northeast Minnesota Economic Protection Trust Funds as allowed by statutory authority. We also recommended that the agency monitor and review the financial activity of the venture capital fund to ensure that it complies with the terms of the financing agreements.

The agency incurred questionable or excessive costs when it sponsored a suite at the Excel Energy Center. The agency held seven events at the suite during Minnesota Wild hockey games in fiscal years 2001 and 2002. The agency held the first four events before it fully executed the sponsorship agreement. The agency needs to document how the costs incurred and the inclusion of spouses and some staff served a public purpose. In addition, when the agency provided lodging to various staff and some attendees for some of the events, it needed to document these related costs on the special expense form. The agency also bartered the use of a suite level boardroom and a $1,500 per year ticket credit to a private company in exchange for the company providing beverages, including alcoholic beverages, for suite events. We recommended that the agency ensure that any disbursement it makes serves a public purpose and provides its primary benefit to the taconite tax relief area.

Agency Background

The Iron Range Resources and Rehabilitation Agency's mission is to coordinate the development of the remaining resources of the taconite tax relief area and contribute toward the vocational training and rehabilitation of the residents in the taconite tax relief area. The taconite tax relief area is an area that encompasses Minnesota's three iron ranges.

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Chapter 1. Introduction

The Iron Range Resources and Rehabilitation entity consists of the Iron Range Resources and Rehabilitation Board (the board) and the Iron Range Resources and Rehabilitation Agency (the agency). The 1941 Legislature created the Iron Range Resources and Rehabilitation Board to strengthen and diversify the economy of northeastern Minnesota. Its mission is to coordinate the development of the remaining resources of the taconite tax relief area and contribute toward the vocational training and rehabilitation of the residents in the taconite tax relief area. The board is composed of five state senators, five state representatives, and three non-legislators who reside in the taconite tax relief area. The taconite tax relief area is an area that encompasses Minnesota's three iron ranges: Cuyuna, Mesabi, and Vermilion. It covers all or portions of Cook, Lake, St. Louis (excluding Duluth), Itasca, Aitkin, and Crow Wing counties. As required by statute, a majority of the legislative members are from state senatorial or legislative districts in which over 50 percent of the residents reside within the taconite tax relief area.

The Governor appoints a commissioner to conduct the administrative operations of the board and the agency. Minnesota Statutes designate the commissioner and other agency employees as part of the executive branch of government. Mr. Jim Gustafson served as the agency commissioner until March 5, 1999. The Governor appointed Mr. John Swift as commissioner effective March 8, 1999.

The agency receives most of its funding from taconite production taxes paid by area mining companies in lieu of local property taxes. The agency uses the taconite production taxes to fund its programs and to provide reimbursement to mining companies for acquisitions and technology improvements. Statutes designate portions of the taconite production taxes to the following accounts and funds:

Agency Board Account
Taconite taxes are the general source of funds for the agency. The agency used these funds for payroll and other operating costs, grants, and loans for economic development.

Taconite Economic Development Fund
The Legislature created the Taconite Economic Development Fund in 1992 to encourage mining companies to reinvest in their operations. The agency credits each mining company's account with their share of the tax. The mining companies can recover these funds for specific projects to enhance the mining industry in Minnesota. For example, mining companies could receive funds to upgrade equipment or develop mining technology. If the mining companies do not use the funds within two years, the statutes reallocate the unused funds to the Taconite Area Environmental Protection Fund and the Northeast Minnesota Economic Protection Trust Fund.

Iron Range Resources and Rehabilitation Agency

Taconite Area Environmental Protection Fund
The Taconite Area Environmental Protection Fund received the largest share of the taconite production taxes. The legislature established this fund to reclaim, restore, and enhance areas within the taconite tax relief area. The agency can use these funds for the following purposes:

- to research environmental problems requiring remedial action;
- to reclaim, restore, or reforest minelands;
- to fund local development projects; and
- to monitor mining employee health problems that may be attributable to the mining industry.

Among its local development projects are the Giants Ridge Golf & Ski Resort and Ironworld Discovery Center. The resort maintains a ski area comprising 34 downhill runs, a snow-sport terrain park, and cross-country ski trails. Giants Ridge also includes a championship 18-hole golf course and is in the process of developing a second 18-hole course. Ironworld is an interpretative center for the mining history in Minnesota. Ironworld hosts various ethnic festivals, concerts, and other events. We discuss these facilities in Chapters 6 and 7.

Northeast Minnesota Economic Protection Trust Fund
The Legislature established the Northeast Minnesota Economic Protection Trust Fund (now designated by statute as the Douglas J. Johnson Economic Protection Trust Fund) in 1977, funding it with a part of the taconite production tax. Statutes restricted the majority of the fund's corpus until 2028. The agency can use the interest earnings and loan repayments to stimulate employment and encourage diversification of the area's economy. At June 30, 2001, the fund balance, including loans receivable, exceeded $130 million.

The agency annually submits its operational budget to the board for approval. The budget lists anticipated revenues and allocates these resources to its divisions, facilities, and administrative services. The agency also submits specific projects to the board for its approval, based on the review and recommendation of the Technical Advisory Committee. The agency submits the projects the board approves to the Governor for final approval. Table 1-1 summarizes the financial activity for the agency for fiscal year 2001.

Table 1-1
Iron Range Resources and Rehabilitation Agency
Fiscal Year 2001 Financial Activity

	Agency Board Account	Taconite Economic Development Fund	Taconite Area Environmental Protection Fund	Northeast Minnesota Economic Protection Trust Fund
Balance Forward In From Prior Fiscal Year	$15,751,035	$1,278,420	$19,085,578	$101,455,576
Revenues:				
Taconite Production Tax	5,928,847	5,992,728	7,713,210	2,036,149
Admissions	2,269,783	0	0	0
Interest	1,067,047	0	1,797,402	4,663,354
Retail Sales	1,095,545	0	0	0
Equipment Rental	327,507	0	0	0
Loan Repayments	80,000	0	0	1,758,508
Revenue Bonds	464,190	0	0	0
Miscellaneous Revenue	836,595	0	0	432,840
Total Revenue	$12,069,514	$5,992,728	$ 9,510,612	$ 8,890,851
Expenditures:				
Salaries and Benefits	2,142,223	0	3,613,466	666,500
Space Rental and Utilities	53,264	0	476,216	9,827
Printing and Advertising	44,577	0	585,331	222,539
Communications	95,246	0	158,555	13,488
Professional Services	724,068	0	2,340,187	285,172
Equipment	144,943	0	223,539	14,268
Indirect Costs	(703,225)	0	739,542	214,339
Maintenance and Repairs	48,726	0	159,406	423
Supplies	253,782	0	582,914	9,250
Travel	170,425	0	97,678	35,665
Other Operational Expenditures	107,147	0	722,431	299,820
Building and Land Improvements	346,788	0	427,728	0
Payments to Individuals	410,000	0	0	0
Grants	8,508,762	5,992,728	4,973,376	2,661,398
Loans	100,000	0	579,359	4,508,309
Debt Service	329,774	0	0	0
Total Expenditures	$12,776,500	$5,992,728	$15,679,729	$ 8,940,997
Excess of Revenues over Expenditures	(706,986)	0	(6,169,118)	(50,146)
Transfers In	550,667	0	0	0
Balance Forward Out To Next Fiscal Year	$15,594,716	$1,278,420	$12,916,460	$101,405,430

Source: Minnesota Accounting and Procurement System

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Chapter 2. Financial Management

Chapter Conclusions

The Iron Range Resources and Rehabilitation Agency's internal controls provided reasonable assurance that it properly recorded its financial activities in the state's accounting system. However, statutory provisions do not clearly define the respective authorities of the board and the agency. The board and the agency also need to develop policies to address the unique conflicts of interest concerns that they may face. The agency also did not adequately restrict access to its accounting systems. The agency's controls provided reasonable assurance that it operated within its budget, but the agency will be challenged to reduce operational costs in light of significant revenue reductions. The agency's per diem payments to board members complied with applicable legal provisions.

Organizational Structure

The iron range resources and rehabilitation organizational structure is unique among state agencies since it is an executive branch agency overseen by a board comprised mainly of members of the Legislature. This executive branch agency reports to the Governor and is responsible for the organization's operation. The board consists of ten legislative members, appointed by the Senate Rules Committee and the Speaker of the House, and three private citizens representing the taconite tax relief area. The board meets approximately four times per year and is responsible for the approval of loans, grants, and other projects. In addition, the Technical Advisory Committee, comprised of local community and business leaders, provides additional oversight for the Northeast Minnesota Economic Protection Trust Fund. This committee operates as an advisory board to the organization and reviews loans before issuance by the agency.

The agency's revenues consisted mostly of taconite production taxes; it also had investment earnings, bond proceeds, and facility fees. Because the agency's revenue is dependent on mining production levels and investment earnings, the decline in mining production and poor investment returns have resulted in significant revenue decline for the agency. For example, the closing of a mining company in fiscal year 2001 reduced revenue by $7 million. Another mining company was late in making its tax payment of $4.2 million in fiscal year 2002. In the short term, the agency can support its operations with funds carried forward from prior fiscal years, but it will need to make some fundamental changes in its organizational structure to successfully maintain its role in the taconite tax relief area. The agency faces the same challenge as the area it serves: it is dependent on a single industry for its livelihood. It will need to focus on its primary mission, redefine its core services, and determine its base level of operational costs to ensure that

it maximizes its opportunities to strengthen and diversify the economy of the taconite tax relief area. The agency will need to better address how it prioritizes the use of its funds and how it measures the results of its efforts. That analysis should question the degree to which the agency uses funds to subsidize internally conducted projects, such as the Giants Ridge Golf & Ski Resort and Ironworld, versus funds that it injects into the business community through grants and loans.

Audit Objectives and Methodology

Our audit scope for financial management focused on the following objectives:

- Did the agency's internal controls provide reasonable assurance that it properly recorded its financial activities on the state's accounting system?
- Did the agency's controls provide reasonable assurance that it operated within its budget and complied with applicable legal provisions and management's authorization?
- Did the agency's payments to board members comply with applicable legal provisions?

To answer these questions, we interviewed the agency employees to gain an understanding of the controls over the recording of financial activities and its budget process. We assessed risks and performed analytical tests to identify possible unusual trends. We reviewed and tested the accounting records to determine whether the agency properly recorded revenues and expenditures in the accounting records. We reviewed compliance with state regulations and analyzed the agency's controls over its investments.

Conclusions

The Iron Range Resources and Rehabilitation Agency's controls provided reasonable assurance that it properly recorded its financial activities on the state's accounting system. The agency's controls provided reasonable assurance that it operated within its budget, but significant revenue reductions will challenge the agency to reduce operational costs. The agency's per diem payments to board members complied with applicable legal provisions. However, statutory provisions do not clearly define the respective authorities of the board and the agency. The board and the agency also need to develop policies to address the unique conflicts that its employees and board may face. The agency also did not adequately restrict access to its accounting systems.

1. Statutory provisions do not clearly define the respective authorities of the board and the agency.

Statutes give the commissioner the authority to use whatever amounts of appropriated funds necessary to accomplish the agency's mission. However, the statutes also state:

> "All expenditures and projects made by the commissioner of iron range resources and rehabilitation shall be consistent with the priorities established . . . and shall

> first be submitted to the iron range resources and rehabilitation board for approval by a majority of the board of expenditures and projects for rehabilitation purposes as provided by this section, and the method, manner, and time of payment of all funds proposed to be disbursed shall be first approved or disapproved by the board."

In addition, before the agency spends some funds, the Technical Advisory Committee must review the projects and make recommendations to the board. Finally, statutes require that the agency needs to obtain the Governor's approval for certain projects.

It seems impractical that the statutes expect the board to approve each individual disbursement. The agency makes from 7,500 to nearly 10,000 non-payroll disbursements each fiscal year. To alleviate this administrative problem, the board seems to have delegated some authority to the agency through the approval of the annual budget. By approving categories of disbursements, the agency believes that the board has given it the authority to spend within that category to the approved amount. For example, the agency's fiscal year 2001 budget included a $300,000 line item for Commissioner's Projects. As the agency used these funds, it did not return to the board for specific project approval. However, when it approved the overall budget for fiscal year 2001, the board directed the agency to continue to submit to the board all business development grant and loan projects for its review and approval.

Board members have at times used the ambiguous statutory authorities to question the actions of a commissioner. For example, questions of whether the commissioner had authority to act arose during the agency's involvement with the Lodge at Giants Ridge (see Chapter 6). Some board members felt that the agency had committed more funds to the Lodge at Giants Ridge than the board had authorized. The board did specifically approve the project and some of the transactions, but the agency initiated other transactions not specifically approved by the board. Agency staff believed that by giving the agency the authority to enter into the project, it gave implicit authority to the agency to manage the project and protect the agency's investment. The unclear statutory language does not contribute to the smooth operations of the agency or its ability to effectively accomplish its mission.

Recommendation

- *The agency and the board need to seek legislative clarification of statutory provisions defining those actions that can be initiated by the agency and those that require specific board approval.*

2. The Iron Range Resources and Rehabilitation Agency does not have a conflict of interest policy that addresses the unique conflicts that its employees and board may face.

Agency staff can have various connections with businesses and local government officials that may appear to result in preferential treatment by the agency or in personal gain to the employee. The agency's mission encourages strong ties with the business communities it serves. At times,

agency staff or family members represented, belonged to, or were employed by organizations that received grant and loan funds. For example, an agency loan officer was on the board of directors of a business that received about $355,000 through grants from the agency. Another agency employee served as the mayor of a city in the taconite tax relief area and represented the city at Iron Range Resources and Rehabilitation Board meetings. There may be a perception that these relationships could result in preferential treatment by the agency, including a less stringent approval process and easier access to grant and loan funds. The appearance of a conflict of interest may impede the agency's success and negatively impact the public's perception of the agency. The sensitive nature of the agency's operations warrants a conflict of interest policy tailored to its environment.

Minn. Stat. Section 43A.38 broadly addresses employee conflict of interest for executive branch employees. It states that it is the employee's duty to avoid a conflict of interest and, should a conflict exist, that the commissioner should reassign the responsibility to another employee. It also states that if it is not possible to reassign the responsibility, interested persons shall be notified of the conflict. The agency should be proactive to define and identify potential employee conflicts. The agency should, when possible, ensure that it removes the employee from any responsibility that may appear to be in conflict with the agency's interest, or notify interested persons about the conflict and monitor the assignment to ensure that it is performed in a fair and equitable manner.

In addition, although the statutory provision does not apply to board members, the board should develop a conflict of interest policy that provides for the identification of a member's conflict of interest and the removal of that board member from any board decision involving the conflict.

Recommendation

- *The agency and the board should design conflict of interest policies that recognize their unique roles in the community and the impact that actual or suspected preferential treatment may have to its integrity.*

3. The agency did not adequately restrict access to its accounting systems.

The agency did not adequately control access to the state's accounting and procurement system or the state's personnel/payroll system. Examples of improper access that existed at the agency included:

- Seventeen of the twenty employees with update access to the state's accounting system had the ability to both initiate a purchase and to disburse funds to pay for the purchase. These are generally considered to be incompatible duties. The state's accounting system security profiles allow for the separation of these incompatible duties between different employees.

- One of the seven employees with access to the state's personnel/payroll system had access to all human resources and payroll functions on the system. An individual with

this dual access could perform unauthorized personnel duties, such as setting up a fictitious employee or changing a pay rate, and then conceal the fraud when processing payroll transactions.

The agency has primary authority and responsibility to ensure that employee access to these systems is limited to an employee's job responsibilities. Without proper access controls, the agency faces increased risk that unauthorized or fraudulent transactions could occur. (We did not detect any evidence of fraudulent transactions.)

Recommendations

- *The agency should restrict system access to only those employees who require the access to perform their job functions. Whenever possible, access to all systems should be designed to maintain a proper separation of duties between accounting functions.*

- *Where the elimination of any incompatible access to the accounting systems is not possible or impractical, the agency should design mitigating controls that would independently monitor the risks posed by such incompatible access.*

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Chapter 3. Northeast Minnesota Economic Protection Trust Fund and the Taconite Area Environmental Protection Fund

Chapter Conclusions

A few financial transactions did not appear to comply with legal provisions: The agency's interpretation and application of statutory administrative cost limitations may not comply with legislative intent. The agency's transactions with a venture capital fund may not have been an authorized use of the Northeast Minnesota Economic Protection Trust Fund. In addition, the agency did not adequately review the venture capital fund's use of Northeast Minnesota Economic Protection Trust Funds nor curtail certain financial activity of the venture capital fund that did not comply with the financing agreement or statutes. Finally, the agency incurred questionable or excessive costs in its sponsorship of a suite at the Excel Energy Center.

In 1977, the Legislature created the Northeast Minnesota Economic Protection Trust Fund (now called the Douglas J. Johnson Economic Protection Trust Fund) and the Taconite Area Environmental Protection Fund to meet certain needs of the taconite tax relief area. Both funds receive funding from a tax on the mining industry. The mining companies pay the tax to the Department of Revenue. In accordance with statutory provisions, the department reallocates the tax to cities, counties, school districts, and other entities, including an allocation to the agency for its general operations and allocations to these two designated funds. While the Legislature dedicated the funds for different purposes, the agency's administration of loans and grants for the two funds is quite similar. In Chapter 4, we discuss the agency's general loan administration process, and in Chapter 5, we discuss the agency's general grant administration process.

The **Northeast Minnesota Economic Protection Trust Fund** provides funds to respond to the severe economic impact that can result when an area is dependent on a single industry. The Legislature dedicated the fund to the economic rehabilitation and diversification of industrial enterprises in the taconite tax relief area. The agency invests the corpus of the trust fund through the Minnesota State Board of Investment. With some limited exceptions, statutes prohibit the use of the trust fund's corpus until 2028, but the agency can use the fund's investment earnings to promote economic development. The agency's Economic and Community Development Division mainly uses loans and grants to assist and encourage businesses to locate or expand in the taconite tax relief area and to help the region's cities and towns deal with growth and change. Table 3-1 shows the trust fund's sources and uses of funds for fiscal years 1999 through 2002.

Table 3-1
Northeast Minnesota Economic Protection Trust Fund
Sources and Uses of Funds
For Fiscal Years 1999 - 2002

	1999	2000	2001	2002
Receipts:				
Taconite Taxes	$ 4,501,065	$ 5,487,705	$ 2,036,149	$ 2,023,700
Interest on Taconite Taxes	194,095	183,863	217,411	210,422
Investment Income	9,751,157	5,492,733	3,690,066	2,152,799
Loan Repayments:				
Principal	1,678,359	3,069,784	1,758,508	1,900,428
Interest	721,086	722,615	755,877	605,581
Facility Leases (1)	37,500	50,000	57,840	85,702
Sale of Building (2)	0	0	375,000	0
Total Receipts	$ 16,883,262	$ 15,006,699	$ 8,890,851	$ 6,978,632
Transfers In	0	0	0	1,271,517
Balance Forward In	86,055,027	99,181,529	101,455,576	101,405,430
Total Sources	$102,938,289	$114,188,228	$110,346,427	$109,655,579
Expenditures:				
Loans	$ 2,054,287	$3,756,734	$ 4,508,309	$ 13,765,001
Grants	584,491	5,312,821	2,661,398	5,956,277
Direct Administrative Costs (3)	857,082	3,136,753	1,556,951	1,559,555
Indirect Administrative Costs	260,900	526,344	214,339	225,523
Total Expenditures (4)	$ 3,756,760	$ 12,732,652	$ 8,940,997	$ 21,506,356
Balance Forward Out	99,181,529	101,455,576	101,405,430	88,149,223
Total Uses	$102,938,289	$114,188,228	$110,346,427	$109,655,579

Note 1: The agency owns two buildings that it leases to businesses.
Note 2: The agency sold the chopstick factory building.
Note 3: Direct administrative costs are all disbursements other than loans, grants, and indirect cost reimbursements to the Agency Board Account. Direct administrative costs may include internally administered economic development projects.
Note 4: Expenditures for fiscal years 2000, 2001, and 2002 included encumbrances totaling $178,276, $440,731, and $3,465,002, respectively.

Source: Minnesota Accounting and Procurement System through September 2002, presented on a budgetary basis.

The Legislature created the **Taconite Area Environmental Protection Fund** to reclaim, restore, and enhance those parts of the taconite tax relief area that are adversely affected by the environmentally damaging mining operations and to promote economic development. The agency's Mineland Reclamation Division reclaims, restores, or revegetates publicly owned lands that have been adversely affected by mining. The agency's Trails Division works with clubs and groups to promote and maintain trails for snowmobile, mountain bike, and hiking use. The division also sponsors special regional events, including snowmobile races, and awards grants for various upkeep, development, and event-related projects. The agency promotes economic development through grants and loans to businesses and communities. The agency also used Taconite Area Environmental Protection Funds to operate the Giants Ridge Golf and Ski Resort (see Chapter 6) and the Ironworld Discovery Center (see Chapter 7) to attract visitors from across the county to the iron range area and to educate the visitors about the cultural traditions of

the region. Table 3-2 shows the fund's sources and uses of funds for fiscal years 1999 through 2002.

Table 3-2
Taconite Area Environmental Protection Fund
Sources and Uses of Funds
For Fiscal Years 1999 - 2002

	1999	2000	2001	2002
Receipts:				
Taconite Taxes	$11,000,476	$12,171,632	$ 7,713,210	$ 6,463,803
Interest on Taconite Taxes	387,255	367,569	434,671	420,370
Investment Income	1,559,990	1,462,612	1,362,731	738,165
Total Receipts	$12,947,721	$14,001,813	$ 9,510,612	$ 7,622,338
Transfers In	0	0	0	3,754,301
Balance Forward In from Prior FY	21,548,752	18,986,395	19,085,578	12,916,460
Total Sources	$34,496,473	$32,988,208	$28,596,190	$24,293,099
Expenditures:				
Loans	$ 0	$ 543,208	$ 579,359	$ 260,000
Grants	6,684,718	3,953,183	4,970,577	6,708,478
Direct Administrative Costs (1)	8,059,472	8,670,207	9,390,252	8,052,429
Indirect Administrative Costs (2)	765,888	736,032	739,542	644,755
Total Expenditures (3)	$15,510,078	$13,902,630	$15,679,730	$15,665,662
Balance Forward Out to Next FY	18,986,395	19,085,578	12,916,460	8,627,437
Total Uses	$34,496,473	$32,988,208	$28,596,190	$24,293,099

Note 1: Direct administrative costs are all disbursements other than loans and grants. Direct administrative costs include any internally administered economic development projects, such as the Giants Ridge Golf & Ski Resort and Ironworld.

Note 2: Indirect administrative costs are the amounts the agency paid to its general operating account to offset the cost of general administration, including the Commissioner's Office, payroll, personnel and accounting functions, and the cost of lighting and heating.

Note 3: Expenditures for fiscal years 2000, 2001, and 2002 included encumbrances totaling $459,629, $933,878, and $3,267,949, respectively.

Source: Minnesota Accounting and Procurement System through September 2002, presented on a budgetary basis.

Audit Objective and Methodology

Our audit of the Northeast Minnesota Economic Protection Trust Fund and the Taconite Area Environmental Protection Fund focused on the following question:

- For the items tested, did the agency comply, in all material respects, with significant finance-related legal provisions applicable to the Northeast Minnesota Economic Protection Trust Fund and the Taconite Area Environmental Protection Fund?

To answer these questions, we reviewed statutes and interviewed agency employees to gain an understanding of the legal provisions applicable to the Northeast Minnesota Economic Protection Trust Fund and Taconite Area Environmental Protection Fund's transactions. We tested a sample of fund transactions to determine whether the agency complied with material finance-related legal provisions. Refer to Chapter 4 and Chapter 5 for conclusions on the agency's

general loan and grant process. Also, refer to Chapter 6 and Chapter 7 for conclusions on Giants Ridge Golf & Ski Resort's receipts and Ironworld Discovery Center's receipts.

Conclusions

A few financial transactions did not appear to comply with legal provisions: The agency's interpretation and application of the statutory administrative cost limitations may not comply with legislative intent. The agency's transactions with a venture capital fund may not have been an authorized use of the Northeast Minnesota Economic Protection Trust Fund. Also, the agency did not adequately review the venture capital fund's use of Northeast Minnesota Economic Protection Trust Funds nor curtail certain financial activity of the venture capital fund that did not comply with the financing agreement or statutes. Finally, the agency incurred questionable or excessive costs in its sponsorship of a suite at the Excel Energy Center.

4. The agency's interpretation and application of the statutory administrative cost limitations may not comply with legislative intent.

The agency only applies the statutory limit on administrative costs in the Northeast Minnesota Economic Protection Trust Fund and the Taconite Area Environmental Protection Fund to costs that it considers "indirect" administrative costs. Statutes for both funds limit "administrative costs" to five percent. The Northeast Minnesota Economic Protection Trust Fund limits the fund's administrative costs to five percent of the prior fiscal years investment earnings. The Taconite Area Environmental Protection Fund limits the fund's administrative costs to five percent of the amount annually expended from the fund. The agency, however, makes a distinction between "direct" administrative and "indirect" administrative, and it only applies the five percent administrative cost limitation to "indirect" administrative costs, such as top management salaries and lighting and heating costs.

A strict definition of an administrative cost might include any disbursement other than a grant or loan to an outside entity. The statute may have intended that all but the five percent of administrative costs should be put to use in the community, not used by the agency to supplement its funding. As a complicating factor, the agency operates some of its economic development projects internally. For example, the agency considers Giants Ridge Golf and Ski Resort and Ironworld to be economic development projects. Costs directly involved in the operation of these projects are project costs rather than administrative costs, and may not be subject to the five percent administrative cost cap. In addition, the agency considers time spent by its development and marketing staff to perform due diligence reviews of grant and loan applications to be an operational cost. However, those activities appear to be more related to administrative functions. The agency may be correct in calling these types of costs "direct" administrative costs, but the distinction between a "direct" administrative cost and an "indirect" administrative cost is one made by the agency, not one made in the statutes.

Another difficulty the agency encountered implementing the administrative cost limitation in the Taconite Area Environmental Protection Fund was that the statutes limited administrative costs to five percent of the amount *annually expended* in the fund. As a practical matter, for budgeting

purposes, agency staff interpreted this to mean five percent of the taconite tax receipts. By basing the administrative cost calculation on the taconite tax receipts, the agency could estimate the amount available for administrative purposes with reasonable accuracy and determine the amount available for grants and other projects.

The agency's distinction between "direct" administrative costs and "indirect" administrative costs and its application of the five percent limitation to revenues rather than amounts expended in the Taconite Area Environmental Protection Fund is long standing, dating back to the late 1970's, when the Legislature created these funds.

Recommendation

- *The agency should obtain legislative clarification of the administrative cost limitations to ensure that its interpretations of these limitations satisfy legislative intent.*

5. The agency's transactions with a venture capital fund may not have been an authorized use of the Northeast Minnesota Economic Protection Trust Fund.

In 1999, the agency gave a non-profit Duluth-based venture capital fund $1 million from the Northeast Minnesota Economic Protection Trust Fund. The fund was managed by a corporation that also managed a for-profit venture capital fund. The venture capital fund pays the corporation six percent of its capital for fund administration. The venture capital fund's mission is to make equity investments in for-profit businesses located within the taconite tax relief area.

The agency executed a financial assistance agreement to support the payment into the venture capital fund. The agreement provided the venture capital fund with interest-free use of the funds, and only required that it repay the funds to the agency if it doesn't achieve a certain level of investments in businesses in the taconite tax relief area by a specified "trigger date." The agency recorded the transaction as a grant on the state's accounting system. In 1998, board minutes authorized an "investment" in the venture capital fund, but before making the payment in 1999, board minutes referred to the transaction as a "project." The agency had previously given the venture capital fund $1 million in 1996 and $250,000 in 1997, under terms that were very similar to the 1999 payment. Table 3-3 recaps these transactions.

Table 3-3
Summary of Payments to a Venture Capital Fund and Financing Terms

Payment Date	Amount	Investment Goal	"Trigger" Date - interest accrual start date if investment goal is not met
May 23, 1996	$1,000,000	$3,000,000	May 23, 2011
March 5, 1997	$ 250,000	$1,000,000	March 5, 2002
November 23, 1999	$1,000,000	$3,000,000	November 23, 2014
	$2,250,000	$7,000,000	

Source: "Financial Assistance Agreements" between the agency and the venture capital fund.

Minnesota Statues authorize the agency to use investment earnings of the Northeast Minnesota Economic Protection Trust Fund for specific purposes. Two of those purposes relate to bond payments and are unrelated to the venture capital fund transactions. The remaining purposes are:

- "To invest in a venture capital fund or enterprise that will provide capital to other entities that are engaging in, or that will engage in, projects or programs that have the purposes set forth in subdivision 1." An investment normally results in some form of equity ownership and an expectation of a return on the investment.

- "To provide loans, loan guarantees, interest buy-downs, and other forms of participation with private sources of financing." The agency has interpreted "other forms of participation" to include awarding grants.

Since the agency's payments to the venture capital fund did not result in any equity interest or any ownership of a share of the fund, it was not an investment. In addition, had these transactions been investments, the agency did not meet other statutory requirements of an equity investment, such as ensuring that the venture capital fund had at least $500,000 already invested from at least two outside investors before the agency's investment. At the time of the 1996 payment to the fund, the agency's attorney general representative questioned how the agency complied with this requirement. In a 1999 memo to the agency he stated, "I continue to have concerns about whether such assistance can be provided under circumstances where . . . the required two non-related investors of at least $500,000 are not identified or may not even be present."

If the transactions were loans, the agency did not comply with certain statutory provisions, since the agency provided the funds interest free until the trigger dates. Statutes require that any loans the agency makes under this section have an interest rate "no less than the lesser of eight percent or an interest rate three percentage points less than the full faith and credit obligation of the United States government of comparable maturity, at the time that the loan is approved." Again, the attorney general's representative questioned the interest free period and the low interest rate after the trigger date.

Finally, if the transactions were an "other form of participation with private sources of funding," allowing the venture capital fund from five to fifteen years to obtain the private sources of funding cannot be considered in accordance with the statute, which implies concurrent participation from private sources.

It is not clear what the agency or the taconite tax relief area gained by entering into these transactions. The financial arrangement took the decision-making control over the proper use of these funds out of the hands of the agency and the board. Also, moving these funds to a venture capital fund for outside investment does not seem to have resulted in a more diverse portfolio. Many of the businesses that received funding through the venture capital fund also received other funding directly from the agency, perhaps resulting in an inappropriately high overall commitment of agency funds. In a 1995 memo, prior to the first $1 million transaction, a venture capital fund representative stated that the transaction would provide venture development capital

to the taconite tax relief area without requiring the agency to either add economic development staff or increase the work load of its current staff. However, the management fees and incentive compensation paid to the fund's administration may have been a higher cost to the agency than adding staff.

The agency asserts that because of its contribution, the venture capital fund was able to attract millions of additional venture capital dollars to the taconite tax relief area. In 1999, the venture capital fund received a $150,000 federal grant. In 2001, the venture capital fund received a $1 million federal grant. The fund designated as matching funds the $1 million it received from the agency in 1999. Also, in 2001, the fund was awarded another federal grant totaling $748,350. By the end of 2001, the fund had invested and drawn down $603,768 of the grant.

Recommendation

- *The agency should only use Northeast Minnesota Economic Protection Trust Funds as allowed by statutory authority.*

6. The agency did not adequately monitor the venture capital fund's use of Northeast Minnesota Economic Protection Trust Funds nor curtail certain financial activity that did not comply with the financing agreement or statutes.

As discussed in Finding 5, the agency gave a venture capital fund $2.25 million from 1996 through 2001. The agency did not adequately review the fund's financial reports. The fund's financial reports for fiscal years 1998 through 2001 and its quarterly investment reports to the agency identified some financial activity that did not comply with the financial assistance agreements. The financial assistance agreements that the agency signed with the venture capital fund for the two $1 million transactions and the $250,000 transaction stated that, "The fund will apply the entirety of the Financial Assistance proceeds to performance of the Project and will not use such proceeds for any other purposes not provided herein." The agreements define the project as the commitment of the venture capital fund, "to use the Financial Assistance proceeds, in conjunction with funds obtained from other sources of funding, to capitalize a fund . . . from which equity investments will be made . . . during the period from the Closing Date to the Trigger Date" in for-profit businesses located in the taconite tax relief area.

The venture capital fund's financial reports included the following information about financial activities that did not comply with the financing agreement or statutory provisions:

- The schedule of portfolio investments in the financial report for December 31, 1999, and the Quarterly Report for the quarter ended December 31, 1999, showed that investments made by the venture capital fund through December 31, 1998, totaled $292,000, although it had received $1 million from the agency in 1996 and $250,000 in 1997. (During 1998, the fund wrote off $142,000 of that investment as a realized loss.)

- The quarterly investment reports identified some of the fund's investments as frequently recurring, working capital loans to a business rather than as equity investments.

- The December 31, 2001, financial report showed a $382,711 notes receivable that a footnote explained as: "Notes receivable consist of short-term advances to portfolio investment companies. The notes, which are due on demand, bear interest at 15 – 18 percent."

- Footnotes to the financial reports disclosed that the venture capital fund paid its parent corporation a management fee. In fiscal years 1999, 2000, and 2001, those fees totaled $72,000, $144,000, and $198,000, respectively. The reports also identified incentive compensation of $10,453, $4,666, and $73,296 for those same periods. The financial assistance agreements do not address the payment of a management fee.

- The December 31, 2001, financial report's Schedule of Portfolio Investments included a $750,000 investment that the venture capital fund did not list on its quarterly investment reports.

The agency's review of the quarterly reports and the annual financial reports did not identify these issues. The agency did not have a timely follow-up with the management of the venture capital fund to ensure that it followed the terms of the financial agreement.

Recommendation

- *The agency should monitor and review the financial activity of the venture capital fund and ensure that it used the $2.25 million in accordance with the financing agreements.*

7. The agency incurred questionable or excessive costs in its sponsorship of a suite at the Excel Energy Center.

In August 2001, the agency signed a three-year Minnesota Wild sponsorship agreement with the facility management firm that operates the Excel Energy Center in St. Paul. The goal of the agreement was to promote northeastern Minnesota as a region abounding in scenic beauty and economic vitality. It allowed the agency to "spread the word" that northeastern Minnesota offered an outstanding workforce, site-location assistance, strong business support, established information technology infrastructure, and a variety of financial assistance programs. The agency believed that the "rich tradition" of hockey in northeastern Minnesota made this agreement a "good fit" and a "great way" to draw attention to the region.

The sponsorship agreement provided the agency with various benefits, including radio and closed circuit television advertisements during Minnesota Wild regular season games, the use of a suite and a boardroom at the Excel Energy Center during three regular season home games, a $1,500 credit toward the purchase of additional tickets at regular season home games, and the right to disseminate information about itself, its programs, or opportunities on the iron range to season ticket holders. In addition, the agency would be designated as the sponsor for the Iron Range Grill and could use its logo and other promotional materials on the grill's napkins, menus,

and signage. The agency believed that the value of the advertising and promotional opportunities it received exceeded the annual cost of the agreement, and that the use of the suite was more of a side benefit.

The sponsorship agreement cost the agency $98,000 per year. As of July 2002, the agency had made two annual payments. The agency used the Taconite Area Environmental Protection Fund to make the August 2001 $98,000 payment and used the Northeast Minnesota Economic Protection Trust Fund to make a series of payments from January 2002 through May 2002 totaling $98,000. In addition, the agency spent nearly $47,500 to create radio promotions to attract businesses to the iron range, and other promotional materials, including menus, napkins, event invitations, wait staff jerseys, and grand opening t-shirts.

The agency held seven events at the suite during Minnesota Wild hockey games in fiscal years 2001 and 2002. The agency held four of the events before it fully executed the sponsorship agreement. It is a poor financial management practice to incur obligations prior to the signing of the agreement. The agency put its resources at risk since the final terms of the agreement may have differed from the understanding at the time the first four events were held. Also, had an agreement not been reached, the agency may have been held liable for the events without knowing the amount of the commitment in advance.

The general focus of the events was either to promote tourism in northeastern Minnesota or to meet with businesses to discuss relocation or expansion in the taconite tax relief area. Attendees included agency staff and board members (and, at times, their spouses), media, and business representatives. Catering costs for the seven events totaled $10,310, with per person costs ranging from $17 at one event to $59 at another. In addition, some staff incurred lodging costs following three of the events. The agency paid over $2,000 for these lodging costs.

The agency did not have a recent special expense plan on file with the Department of Employee Relations for its anticipated exceptions to typical state expense guidelines. The agency also had not submitted amendments or requested approval for specific special expenses since 1997. The Department of Employee Relations requires that agencies submit an annual special expense plan for its approval as a way to control the types of special expenses the state incurs and to ensure that the expenses are necessary and serve a public purpose. It also requires that an agency submit detailed special expense forms when it intends to incur expenses other than those identified in an approved plan.

The agency completed a special expense form for one of the seven events, but did not submit it to the Department of Employee Relations. The form stated that that catering costs would not exceed $800. However, a fax to the caterer on that same date ordered a $51.50 per person menu selection for 30 people, and totaled $1,951, including tax and service charges. The agency also listed only four agency staff as attendees to the event, when actual attendance included six agency staff, two spouses of staff members, three board members, and one guest of a board member. The agency needs to document how the inclusion of spouses and staff not initially identified on the special expense form served a public purpose. In addition, when the agency provided lodging to various staff and some attendees for some of the events, it needed to document these related costs on the special expense form.

Iron Range Resources and Rehabilitation Agency

The agency gave the use of the suite level boardroom and the $1,500 per year ticket credit it received as part of the sponsorship agreement to a private company in exchange for the company providing beverages, including alcoholic beverages, for suite events. State policy prohibits the use of public funds for alcoholic beverages. It is questionable whether the agency has authority to barter for goods and services normally prohibited by state policy.

In May 2002, the Legislature amended Minn. Stat. Section 298.22 and added the following section:

> In the promotion of tourism, trade, and economic development, the commissioner may expend money made available to the agency under section 298.28 in the same manner as private firms, corporations, and associations make expenditures for these purposes. An expenditure for food, lodging and travel is not governed by the travel rules of the commissioner of employee relations.

The agency should not consider this legislation as authorization for unrestricted use of dedicated funds. It is critical that the board and the agency define the scope and limitations of this authority. The special expense form already allows for expenses and reimbursements that exceed normal state travel rules, but also provides guidelines and limitations considering that any use of public funds must serve a public purpose. The agency needs to establish its own definition of reasonable and allowable expenses. For any expenditure, the agency needs to determine and document that a public purpose is served, and that the benefit to the taconite tax relief area is not merely incidental but primary. In developing its policy, the agency should consider the risk of liability when it provides alcohol at agency-sponsored events.

Recommendations

- *The agency should not incur liabilities or encumber funds until it fully executes a contract.*

- *The agency should ensure and document that any disbursement it makes serves a public purpose and provides its primary benefit to the taconite tax relief area.*

- *The agency should follow the state's special expense policies when it anticipates incurring expenditures that exceed amounts allowed under regular state expense guidelines.*

- *The agency and the board should develop a policy to define the reasonable and allowable expenses it can incur under the new legislation.*

Chapter 4. Economic Loan Program

Chapter Conclusions

The agency issued a loan to refinance a business' existing debt, which agency loan guidelines prohibit. In addition, the agency did not appropriately consider information about the company's current financial status when making the loan. Finally, the agency did not reconcile its cash receipts log to cash deposits.

As part of its mission to strengthen and diversify the economy of the taconite tax relief area in northeastern Minnesota, the agency developed a loan program to assist businesses in the creation and maintenance of productive, permanent skilled employment. Under the program, the agency loaned funds to help finance projects that promote manufacturing or develop technologically innovative businesses, minerals, forestry, wood products, and tourism. Table 4-1 displays the loan activity for the period from July 1, 1998, through June 30, 2001.

Table 4-1
Loan Activity
For the Period July 1, 1998, through June 30, 2001

	1999	2000	2001
Loans Outstanding – Beginning Balance	$31,095,287	$31,590,492	$32,035,738
New Loans Issued	2,642,056	3,918,781	5,917,730
Principal Repayments	(1,821,272)	(3,368,808)	(1,838,508)
Loans Forgiven – Northwest Airlines (1)	0	0	(8,686,275)
Loans Written Off	(325,579)	(104,727)	(249,064)
Loans Outstanding – Ending Balance	$31,590,492	$32,035,738	$27,179,621
Less Reserve for Uncollectible Loans	(2,042,217)	(2,348,983)	(3,131,973)
Net Loans Receivable	$29,548,275	$29,686,755	$24,047,648

Note 1: The agency forgave an outstanding loan balance from Northwest Airlines of $8,686,275 on March 30, 2001, when the company satisfied conditions of the original loan agreement.

Source: Minnesota Comprehensive Annual Financial Report and supporting schedules.

The agency can loan funds directly to a business or can participate with a commercial bank or other regulated lender to fund a portion of a loan. The agency targets the loans to the establishment of new businesses or the expansion of existing businesses within the taconite tax relief area. Statutes limit the amount that the agency can loan to a private entity to a maximum of 50 percent participation in the financed eligible costs. Minnesota Statutes require the minimum interest rate be determined by taking the lesser of eight percent or the rate of a comparable United States Government obligation less three-percentage points.

Whenever possible, the agency used the participation loan process to finance business development projects. The participating bank originated the loan documents and administered

the credit. The participation loan agreements allow the bank to retain a .05 percent fee for their services. The agency generally requires a shared first position with the bank on the collateral securing the financing.

The agency's three full-time loan officers review each project and the related documentation. The preliminary application process requires the applicant to submit information describing the business for which the project is proposed, details of the proposed project, the uses of requested loan funds, the collateral for the loan, and information about other sources of financing for the project. If the agency's Economic Development Division approves the preliminary application, it invites the applicant to submit a full application, which requests more in-depth information about the business and the purpose of the loan and identifies and values the loan's collateral.

If the agency's Economic Development Division approves the loan package, it forwards it to the commissioner for his approval. The loan officers then present projects to the agency's Technical Advisory Committee for their review. The Technical Advisory Committee is a volunteer economic advisory group composed of area business people who review loan projects for credit worthiness. Although the statute does not require approval of a project by the Technical Advisory Committee, projects seldom advance without the Technical Advisory Committee's recommendation. Next, the agency forwards recommended projects to the board for its approval. Eight or more board members must approve each loan. The Governor must also approve loans from the Northeast Minnesota Economic Protection Trust Fund before the agency can disburse the loans.

The agency uses the state's accounting system to record all loan disbursements and repayments. In addition, the agency maintains a subsidiary loan database which tracks all loan disbursements, payments of principal and interest, write-offs, and receivable balances for each loan. The agency regularly balances the receivable balances on the subsidiary loan database to the state's accounting system. Loan officers can view all data in the subsidiary loan database and produce reports that alert them to loans that are past due. The loan officer who originated the loan is responsible to follow up on that loan if it becomes delinquent. The loan officers contact delinquent borrowers, in the case of direct loans, or contact the participating lending institution, in the case of participation loans.

Audit Objectives and Methodology

Our audit of the agency's Economic Loan Program focused on the following questions:

- Did the agency's controls provide reasonable assurance that it accurately recorded loans and loan collections in the accounting records and complied with management's authorization?

- For the items tested, did the agency comply, in all material respects, with significant finance-related legal provisions and agency loan policies?

To answer these questions, we interviewed the agency employees to gain an understanding of the control structure in place over the loan issuance and repayment process. We performed detailed

testing of loan disbursement and repayment transactions to determine whether internal controls were operating properly and that loans complied with material finance-related legal provisions and the agency loan policies.

Conclusions

The agency issued a loan to refinance a business' existing debt, which agency loan policy prohibits. In addition, the agency did not appropriately consider information about the company's current financial status when making the loan. Finally, the agency did not reconcile its cash receipts log to cash deposits.

8. The agency issued a loan to a business to refinance existing debt, which agency loan guidelines prohibit. In addition, the agency did not reconsider the issuance of the loan after receiving audited financial statements that showed a significantly poorer financial position than that presented in the business' loan application.

The agency and the board approved a $400,000 loan to a business and a $200,000 purchase of the company's preferred stock with funds from the Northeast Minnesota Economic Protection Trust Fund. The loan agreement stated that the business would use the loan proceeds, in part, to refinance exiting debt. When the agency issued the loan in March 2001 the company had a $200,000 note payable to a local lender. The agency's loan guidelines state, "Loan proceeds cannot be used for debt refinancing." The agency needs to ensure that it uniformly applies its guidelines to avoid the appearance of impropriety. When it deviates from its guidelines, the agency should document the reasons for the deviation.

In addition, the agency based its approval of the loan/equity purchase on the business' preliminary, unaudited financial data. In February 2001, the agency received audited financial statements for the company. The audited financial statements showed that the original data provided by the manufacturing firm contained material overstatements of the company's assets and net income. The audit report noted that the company's current liabilities exceeded current assets by $150,000. The auditor also raised concerns about the manufacturing firm's ability to continue as a going concern. After receiving this information, the agency's Economic Development Division did not reconsider the decision to issue the loan and purchase the equity investment, and did not report this new financial information to the board. The agency should consider the most current and accurate financial information in evaluating the feasibility of a loan. By not providing the most current information to the board, the agency is not complying with the statutory approval process.

Recommendations

- *The agency should follow its loan guidelines and document the reasons for any deviations from the guidelines.*

- *The agency should consider the most accurate and timely financial information from loan applicants and submit accurate and timely information to the board.*

9. The agency did not reconcile the daily cash receipt log to the bank deposit records.

Although the agency's receptionist prepared a check receipt log at the time that she opened the mail, no one compared this log to the bank deposit prepared by the accounting department. The agency received nearly $2 million for repayment of loan principal and interest in fiscal year 2001, along with other accounts receivable payments. A comparison of the check log to the deposit slips by someone independent of this process would provide assurance that the agency deposited all cash received.

Recommendation

- *The agency should assign an independent staff person to periodically reconcile the check log to the deposit records.*

Chapter 5. Grant Expenditures

Chapter Conclusions

The agency's process for selecting grant projects needs improvement. In addition, the agency did not comply with retainage requirements mandated by some grant contracts. The agency also improperly issued grants for professional/technical service projects.

The taconite production tax provided the funding for the agency's grants to counties, cities, school districts, higher education institutions, and other non-government organizations located within the taconite tax relief area. The agency also disbursed taconite tax collections back to the mining companies for special projects. The agency allocated the taconite tax proceeds to specific program areas, such as economic and community development, business recruitment, and tourism.

Each grant project must go through an approval process. Minnesota statutes require that the board and the Governor approve projects financed by the Taconite Area Environmental Protection Fund. In addition, a technical advisory committee must review projects financed by the Northeast Minnesota Economic Protection Trust Fund before the board and the Governor approve the projects.

The taconite production tax collections have decreased between fiscal years 1999 and 2001. Grant expenditures have also decreased. Table 5-1 highlights the agency's grant disbursements for fiscal years 1999, 2000, and 2001.

Table 5-1
Grant Expenditures
For Fiscal Years 1999 - 2001

	1999	2000	2001
Counties, Cities and Other Governments	$ 6,824,440	$ 6,278,958	$ 5,162,353
School Districts and Higher Education Institutions	161,210	309,809	458,413
Non-Government Organizations	15,653,737	14,499,019	11,599,372
Total Grant Expenditures	$22,639,387	$21,087,786	$17,220,138

Source: Minnesota Accounting and Procurement System.

Iron Range Resources and Rehabilitation Agency

Audit Objectives and Methodology

Our audit of grant expenditures focused on the following objectives:

- Did the Iron Range Resource and Rehabilitation Agency's internal controls provide reasonable assurance that it accurately reported grant expenditures in the accounting records and complied with applicable legal provisions and management's authorization?

- For the grants tested, did the Iron Range Resource and Rehabilitation Agency comply with significant finance-related legal provisions concerning grant expenditures?

To answer these questions, we obtained an understanding of the internal control structure over the grant issuance and disbursement processes. We reviewed controls and tested transactions related to grant disbursements. We tested grant transactions to determine whether the agency received proper authorization for grant projects and to determine whether the grantee complied with grant provisions before receiving funds. We also reviewed the reasonableness of each grant tested to see that it complied with statutory requirements.

Conclusions

The agency's process for selecting grant projects needs improvement. In addition, the agency did not comply with retainage requirements mandated by some grant contracts. The agency also improperly issued grants for professional/technical service projects.

10. The agency's process for selecting grant projects needs improvement.

The agency could improve its grant award process by formalizing selection criteria. Although it does have an application manual for community development grants, the agency does not have guidelines or criteria for the ranking of grant projects. The agency had not established clear criteria to assist staff in the determination of the project's eligibility or the prioritization of various applications. The projects that the agency recommends to the board for its approval are subject to the discretion of agency staff. In addition, while most applicants submitted grant requests to the agency staff, some applicants give the grant requests to board members. This may allow the board to approve project requests before the agency has adequately reviewed their merits.

The agency receives grant requests for many types of projects. If the agency were to develop specific plans and goals that it would like to accomplish, it could narrow its selection of grant projects to those that meet these objectives. The agency and the board need to work together to develop new procedures to ensure that it submits all projects to the board for approval, and that the agency submits all necessary information to the board in a timely manner. This process may result in a more successful approach to economic development issues in the taconite tax relief area.

Recommendation

- *The agency needs to work with the board to develop grant selection guidelines that allow it to appropriately rank grant applications and ensure that it awards grants objectively to projects that further the agency's mission.*

11. The agency did not comply with retainage requirements mandated in some grant contracts.

The agency did not retain funds for grant projects that had a retainage clause in the grant contract. We tested 19 grants and identified six grants ranging from $26,000 to $2.1 million that had retainage clauses in the grant agreement. The six grants included four construction projects and two technology education projects. The retainage clause in the grant agreements stated that the agency would retain five percent of the grant amounts until receipt of final accounting reports. For all six grants, the agency did not retain five percent and did not receive the final accounting reports.

The agency risks making final payments to recipients that have not appropriately completed their projects. The agency needs to improve its process of monitoring grant projects to ensure that it retains required amounts until it receives final accounting reports. The agency should develop a checklist of grant requirements to help it manage its grant projects.

Recommendations

- *The agency should improve its grant monitoring process to ensure it does not disburse money before the grantee meets the goals of the grant project and has submitted final accounting reports.*

- *The agency should develop a checklist that it can use to track the grant information required before the disbursement of grant funds.*

12. The agency improperly issued grants for professional and technical services.

The agency issued nearly $300,000 between fiscal years 1999 and 2002 to a vendor for projects that were professional and technical in nature and included:

- The vendor received over $53,000 to help sponsor services for the Governor's Golf Challenge event.

- The vendor received $5,800 to help the agency complete a loan application with the U.S. Department of Agriculture.

- The vendor used grant funds to schedule speakers for training seminars and for a variety of other special marketing and recruitment initiatives.

The agency did not comply with the professional and technical service guidelines listed in Minn. Stat. Section 16C. Generally, grants are intended for projects that benefit a third party. If the agency received professional and technical services, the statute requires the agency to issue contracts. The Department of Administration is responsible for overseeing the state's professional and technical contract process and advised us that the agency should have issued contracts for the services listed above. The agency must follow statutory guidelines, such as obtaining bids and approval for certain dollar thresholds, before completing a contract. By setting up professional and technical service projects as grants, the agency is circumventing the state's procurement process.

Recommendation

- *The agency should comply with statutory regulations and issue contracts for professional and technical services.*

Chapter 6. Giants Ridge Golf & Ski Resort Receipts

Chapter Conclusions

The Iron Range Resource and Rehabilitation Agency's internal controls provided reasonable assurance that it accurately recorded Giants Ridge Golf & Ski Resort receipts in the accounting records and complied with applicable legal provisions and management's authorization. For the items tested, the Iron Range Resources and Rehabilitation Agency complied with significant legal provisions concerning Giants Ridge Golf & Ski Resort receipts.

Giants Ridge Golf & Ski Resort

To diversify the economic base of the taconite tax relief area and increase the area's attractiveness to tourists, the agency operates the Giants Ridge Golf & Ski Resort (Giants Ridge). The agency opened Giants Ridge in 1984 as a ski hill. Since then, the agency has modernized and developed the facility. In 1997, the ski resort expanded to a year-round attraction by adding an 18-hole golf course and, in 1999, an on-site hotel/restaurant facility. The agency is developing a second golf course, scheduled to open in 2003, costing an estimated $9.5 million.

The agency contracts with outside management companies to manage certain resort operations, including:

- **Golf and Concessions**: Since the golf course opened in 1997, the agency has had three golf management companies: Evergreen Alliance Golf Limited was the manager from 1997 through March 2001, Golf Matrix from April 2001 through December 2001, and Troon Golf Company since January 2002. The agency collects and deposits all of the golf and concession receipts and pays the management firm a set fee and an annual incentive fee based on the prior year's receipts. The golf management company received approximately $6,000 a month as a fixed management fee.

- **Ski Rental and Gift Shop**: Northern Lights Sports is the management company for the ski rental shop and gift shop. The agency collects and deposits the ski rental receipts from which it retains 20 percent as a fee. Northern Lights collects and deposits the gift shop's receipts and pays a percentage back to the agency.

- **Coffee Shop**: Northern Expresso manages a coffee shop located within the ski chalet. The coffee shop collects and deposits the receipts and pays a set fee of approximately $1,600 each ski season to the agency.

Table 6-1 summarizes Giants Ridge's financial activity for fiscal years 2000 and 2001.

Table 6-1
Giants Ridge Revenues & Expenses
For Fiscal Years 2000 and 2001

	2000	2001
Revenues:		
Golf Revenues	$1,797,788	$1,707,094
Ski Revenues	966,908	1,244,254
Concession Revenues	578,559	578,601
Real Estate Revenues	7,714	207,064
Total	$3,350,969	$3,737,013
Expenses:		
Salaries and Benefits	$1,148,926	$1,303,536
Management Fees and Expense Reimbursements	1,445,708	1,439,192
Advertising	228,255	282,185
Utilities	237,841	219,227
Supplies	170,049	183,907
Depreciation	793,572	835,235
Other	429,870	554,505
Total	$4,454,221	$4,817,787
Operating Loss	($1,103,252)	($1,080,774)

Source: Giants Ridge Annual Financial Report for the fiscal year ended June 30, 2001.

As shown in Table 6-1, the agency significantly subsidizes Giants Ridge's operations. The agency has to determine whether the overall benefit to the taconite tax relief area (the employment the resort provides to local residents and the tourism dollars it attracts) outweighs the loss that the agency subsidizes.

The Lodge at Giants Ridge

The Lodge at Giants Ridge (the lodge) opened in December 1999. The board anticipated that a hotel at the resort would provide more employment opportunities to local residents, entice more tourists, and increase the tax base. They approved the construction of a privately owned hotel within the Giants Ridge Ski and Golf Resort. The agency leased land to Giants Ridge Lodge, LLC (the company) and entered into an agreement with it for the construction and ownership of the lodge. The board approved $3,260,000 from the Taconite Area Environmental Protection Fund to be used as follows: a) $1,850,000 for the hotel's restaurant/bar/kitchen development that the agency would lease from the company and operate through a management company; b) $760,000 for a new ski maintenance building; c) $350,000 to convert the old maintenance building into a golf pro shop; d) $250,000 for other site development costs, such as parking and landscaping; and e) $50,000 for contingencies. The company obtained a $6,500,000 construction loan and expected to raise an additional $3,450,000 by selling ownership shares in the company. The company structured the ownership shares into three classes of ownership, as follows:

- **Class A** – This class had 16 units of membership at $100,000 per unit, which the company intended to sell to private investors. The company sold one half unit for $50,000 to the future restaurant's manager, MHC Lodging, LLC, who agreed to purchase another half unit at a future time. The company did not find other private investors. This $1,550,000 capitalization shortfall caused significant cash flow problems for the project. To allow the project to continue, the board approved a $500,000 letter of credit to the company from the Taconite Area Environmental Protection Fund, which the agency later converted, as allowed by the terms of the letter of credit, to five units of Class A ownership. The agency purchased an additional 3.5 units for $350,000, from the Taconite Area Environmental Protection Fund. The agency's purchase of these Class A shares gave it majority ownership in the company, which the agency believed allowed it to better control the future of the project.

- **Class B** – The agency purchased all 30 units for $1,850,000 from the Taconite Area Environmental Protection Fund, as authorized by a 1998 board resolution.

- **Class C** – Five parties (Giant Ridge Partners; Village Enterprises, LLC; Amcon Giants Ridge, LLC; Tim Chies; and Renaissance Land Company) made up the Class C ownership. Each party paid $100 capital contributions, and most parties also provided a personal guarantee for the construction loan the company obtained from Guardian Capital, Inc. (GCI)

The corporation's Board of Governors consisted of one representative from each class. Initially, the agency's director of Giants Ridge development represented Class B, and later, the agency's deputy commissioner represented Class A.

As the project progressed, the company continued to have cash flow problems and was ultimately unable to make payments on the construction loan. In keeping with the development agreement and to delay foreclosure, the agency made several $60,000 mortgage payments and provided various cash flow advances to the company. Disputes between the Class C parties and the agency resulted in three major lawsuits: (1) Lakehead Constructors, the construction company, filed a lawsuit in April 2001 against Giants Ridge LLC and the agency for not making payment on over $875,000 for work that it performed. (2) In May 2001, the Class C investors filed a lawsuit against the agency for several reasons. They contended that the agency did not do enough to promote the lodge and that the agency blocked the Class C involvement by obtaining two seats on the governing board. The Class C investors also claimed that the agency did not provide preferential tee times to guests at the lodge, which was agreed upon in the development agreement. (3) GCI, Inc. filed a lawsuit against Giants Ridge Inc. and the agency for defaulting on the mortgage. GCI claimed that the amount owed was $6,685,440.

Table 6-2 summarizes the agency's investment in the lodge.

Table 6-2
The Agency's Investment in Giants Ridge Lodge

Date	Description	Amount
January 1999	Purchase of 30 Class B Units	$1,850,000
June 2000	Letter of Credit Converted to 5 Class A Units	500,000
June 2000	Purchase of 3.5 Class A Units	350,000
January 2000 – December 2001	Advances & Loan Payments	789,436
	Total	$3,489,436

Source: Minnesota Accounting and Procurement System.

The Sixth Judicial Court dismissed the lawsuits in April 2002 as part of a settlement agreement in which the agency gave up their ownership interests in the lodge. The agency conveyed the land beneath the lodge to new owners, Hotel Capital Partners XXIV, LLC, a Sundance Lodging company. The agreement released the agency from making any settlement payments to the plaintiffs. Many of the original Class C owners are members of a minority ownership group.

Audit Objectives and Methodology

Our audit of Giants Ridge Receipts focused on the following objectives:

- Did the Iron Range Resource and Rehabilitation Agency's internal controls provide reasonable assurance that it adequately safeguarded and accurately recorded Giants Ridge receipts in the accounting records, and that it complied with applicable legal provisions and management's authorization?
- For the transactions tested, did the Iron Range Resource and Rehabilitation Agency comply with significant finance-related legal provisions concerning Giants Ridge receipts?

To answer these questions, we obtained an understanding of the internal control structure over Giants Ridge receipts. We tested a sample of receipt transactions to determine whether the agency accurately collected and recorded receipts in the accounting system. We also reviewed supporting documentation to determine if the agency timely deposited the receipts. (We included Giants Ridge's expenditures in our examination of payroll and other operating expenditures, as explained in Chapters 8 and 9.)

Conclusions

The Iron Range Resource and Rehabilitation Agency's internal controls provided reasonable assurance that it accurately recorded Giants Ridge receipts in the accounting records and complied with applicable legal provisions and management's authorization.

For the items tested, the Iron Range Resource and Rehabilitation Agency complied with the significant finance-related legal provisions for Giants Ridge receipts.

Chapter 7. Ironworld Discovery Center Receipts

Chapter Conclusions

The agency had some weak controls over the receipt process and did not always promptly deposit or record receipts. The agency also did not charge other agencies for archival services at Ironworld.

Ironworld Discovery Center's mission is to preserve and promote the historical and cultural heritage of the Iron Range. The agency promotes this mission by providing public access to the Iron Range Research Center's library and archival service, open all year long, and by operating a summer visitor attraction servicing local residents and the tourist market. Open seven days a week, June through September, Ironworld Discovery Center (Ironworld) served over 97,000 visitors and event attendees during the three years ended June 30, 2001.

In addition, Ironworld holds several festivals, including the International Polka Fest, Minnesota Ethnic Days, the International Button Box Festival, and Festival Finlandia. These events draw more than 16,000 people each year. Included in the festivals are live music, dancing, ethnic foods and educational workshops. The American Bus Association named the Polka Fest in its Top 100 Events, and the Minnesota Office of Tourism included it in the state's Top 25 Events. The agency plans each of these heritage events in association with a volunteer committee comprised of local community members. These committees meet throughout the year with Ironworld staff and offer their expertise, enthusiasm, and creative guidance for heritage programming.

Financial Activity

Ironworld's main source of revenue was admission fees during the summer season. Other sources of receipts included fees from the research center and mini-golf, and commissions from the gift shop. It also had some lease income. Ironworld accounted for daily admission receipts on a stand-alone computer system. The system reconciled receipts to tickets sold on a daily basis. Since the system did not interface with the state's accounting system, facility staff manually entered receipt transactions on the state's accounting system.

Table 7-1 summarizes Ironworld's revenues and expenditures for fiscal years 1999-2001.

Table 7-1
Ironworld
Schedule of Revenues and Expenditures
By Budget Fiscal Year

	1999	2000	2001
Revenues:			
Admissions	$ 173,643	$ 180,986	$ 192,566
Retail Sales	122,096	155,900	244,725
Sponsorships	23,200	32,775	46,373
Facility Lease Rental	16,190	40,509	54,419
Miscellaneous Revenue	94,868	45,470	40,248
Total Revenues	$ 429,997	$ 455,640	$ 578,331
Expenditures:			
Salaries and Benefits	$ 957,792	$1,037,458	$1,107,791
Space Rental and Utilities	135,882	140,241	187,392
Printing and Advertising	107,269	141,641	133,832
Professional Services	217,164	173,729	351,282
Communications	34,952	47,251	33,056
Travel	14,382	24,314	14,959
Supplies	97,356	101,124	237,272
Equipment	19,373	16,411	57,096
Repairs & Maintenance	40,441	22,218	47,527
Other Expenditures	299,567	387,165	270,628
Total Expenditures	$1,924,178	$2,091,552	$2,440,835
Income (Loss)	($1,494,181)	($1,635,912)	($1,862,504)
Attendance	38,719	33,340	25,489

Sources: Minnesota State Accounting and Procurement System and Ironworld's attendance records.

Audit Objectives and Methodology

Our audit of Ironworld focused on the following objectives:

- Did the agency's controls provide reasonable assurance that it adequately safeguarded and timely deposited its receipts, accurately recorded receipts in the accounting records, and complied with applicable legal provisions and management's authorization?

- For the items tested, did the agency comply, in all material respects, with the significant finance-related legal provisions concerning receipts?

To meet these objectives, we reviewed the controls over the collection of receipts at Ironworld. We tested admission fees, season passes, and other daily receipt transactions to determine

whether the agency properly recorded receipts in the accounting records and complied with material legal provisions. We also tested contracts with concession and gift shop vendors to determine the accuracy of commission amounts, and whether the agency properly recorded commissions in the accounting records. (We included Ironworld's expenditures in our examination of payroll and other operating expenditures, as explained in Chapters 8 and 9.)

Conclusions

The agency had some weak controls over the receipt process and did not always promptly deposit or record receipts. The agency also did not charge other agencies for archival services at Ironworld.

13. The agency had some weak controls over the receipt process and did not always timely deposit or record receipts.

At certain times, the same staff person was responsible for collection of the receipts, depositing those receipts in the bank account, recording of the receipts on the state's accounting system, and reconciling the bank account. This lack of separation of incompatible duties increased the risk that errors or irregularities could occur without detection.

In addition, the agency could not locate certain records supporting receipt transactions. For example, the agency could not locate bank deposit slips supporting 10 of the 24 tested deposits. The agency needs to develop a method of storing financial records that allows it to locate documents supporting financial transactions in a timely manner.

Finally, the agency did not always promptly deposit Ironworld receipts in the bank or record receipts on the state's accounting system on the date received. The agency waited from four to seven days to deposit receipts in 14 of 24 of the deposits tested. Minnesota statutes require agencies to deposit receipts of $250 or more on a daily basis. The agency's delay in depositing the receipts increased the risk of loss or theft of funds. In addition, the agency could not record these receipts in the state's accounting system until the agency deposited these funds.

Recommendations

- *The agency should separate the incompatible duties of collecting, recording, and depositing receipts. If separation of these duties is not possible, the agency should implement adequate procedures, such as a timely review of documentation supporting receipt transactions, to detect an error or irregularity.*

- *The agency should ensure that it maintains documentation to support its receipt transactions.*

- *The agency should deposit receipts as required by statute and promptly record receipt transactions on the state's accounting system.*

14. The agency did not charge other agencies for archival services at Ironworld.

As part of its research center, Ironworld stored and cataloged documents and other records for local units of government, cities and townships, and for private individuals. Ironworld absorbed the cost of operating the archive service. Statutes allow the agency to charge fees for the use of facilities if it sets the fee to recover its operating costs and if the fee is based on the prevailing market rate. The agency should maximize its revenue potential by charging for these services.

Recommendation

- *Ironworld should consider charging a fee for its archival services to recover the cost of providing this service.*

Chapter 8. Payroll

Chapter Conclusions

The agency's internal controls provided reasonable assurance that it accurately compensated employees in compliance with the applicable bargaining agreements and management's authorization, and that it authorized and properly recorded payroll transactions in the state's accounting and payroll systems. For the items tested, the agency complied, in all material respects, with the significant finance-related legal provisions concerning payroll. However, as explained in Chapter 2, Finding 3, the agency did not adequately restrict access to its payroll/personnel and accounting systems. In addition, the agency did not adequately separate incompatible payroll and personnel duties and had an excessive number of employees working out of class.

Employee payroll expenditures (including payroll expenditures for Giants Ridge Golf & Ski Resort and Ironworld) was the agency's largest administrative expenditure category and totaled $18,109,142 for the three years ended June 30, 2001. The agency employed approximately 82 full-time and 18 part-time employees as of May 7, 2002. The agency's employees participated in the following bargaining agreements and personnel plans:

- American Federation of State, County, and Municipal Employees
- Minnesota Association of Professional Employees
- Middle Management Association
- Managerial Plan
- Commissioner's Plan

The agency processed bi-weekly payroll transactions and pay rate changes through the state's personnel/payroll system. Table 8-1 summarizes payroll expenditures for the three fiscal years ending June 30, 2001.

Table 8-1
Summary of Payroll Expenditures
By Budget Fiscal Year

	1999	2000	2001
Full-Time	$5,073,723	$5,339,033	$5,067,282
Part-Time	182,725	412,773	782,147
Overtime Pay	61,613	66,129	96,778
Premium Pay	21,768	22,497	32,893
Other	180,960	580,803	188,018
Total Payroll Costs	$5,520,789	$6,421,235	$6,167,118

Source: Minnesota State Accounting and Procurement System.

Audit Objectives and Methodology

We focused on the following objectives during our audit of payroll expenditures:

- Did the agency's internal controls provide reasonable assurance that it accurately reported payroll expenditures in the accounting records and complied with applicable legal provisions and management's authorization?

- For the items tested, did the agency comply, in all material respects, with the significant finance-related legal provisions concerning payroll?

To address these objectives, we completed an analytical review of payroll expenditures by type and investigated any unusual trends and amounts. We reviewed controls over the processing of payroll transactions, including leave. We reviewed system access controls to the state's personnel/payroll system. We tested compliance with the agency's early retirement plan submitted to the Department of Employee Relations.

Conclusions

Generally, the agency's internal controls provided reasonable assurance that it accurately recorded payroll expenditures in the accounting records and complied with applicable legal provisions and management's authorization. For the items tested, the agency complied with the significant finance-related legal provisions concerning payroll. However, as explained in Chapter 2, Finding 3, the agency did not adequately restrict access to its payroll/personnel and accounting systems. In addition, the agency did not adequately separate incompatible payroll and personnel duties and had an excessive number of employees working out of class.

15. The agency did not adequately separate incompatible payroll and human resource duties.

One employee performs most personnel duties, including establishing new employees on the personnel/payroll system and entering increases in payrates. This employee and a backup employee also can change their own records in the personnel and payroll system. No one independent of these duties reviews the personnel output for errors. Good internal controls would provide for an independent review of the personnel entry data to ensure accuracy.

In addition, the agency did not independently verify that payroll transactions were properly entered into the state's personnel/payroll system. The payroll clerk who entered timesheet hours into the state's personnel/payroll system during mass time entry also verified the accuracy of the posting. This increases the risk that an inaccurate posting of hours worked or leave taken could occur and go undetected. An independent review of the payroll register report would ensure that payroll errors do not occur or are detected and corrected in a timely manner.

Recommendation

- *The agency should separate incompatible human resource and payroll duties, including establishing an independent verification of the hours reported on timesheets to the hours processed in the state's personnel/payroll system.*

16. The human resources division did not adequately monitor vacant positions and staff working out of class.

During the three years ended June 30, 2001, 20 of the agency's 82 employees had worked out of class, including eight employees who worked out of class for periods exceeding a year. Usually an employee worked out of class as a temporary solution to fill a vacant position until the agency could permanently fill the position or the vacancy no longer existed. State policy allows an agency to make a temporary appointment of up to six months and can extend the appointment to one year, but the policy prohibits work out of class assignments from exceeding one year. The human resources division should have better monitored the status of work out of class assignments and ensured that the agency did not exceed the one-year limit. The human resources division should have better helped the agency to more timely fill vacant positions.

Recommendation

- *The agency should more timely fill vacant positions and better monitor the status of employees working out of class.*

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Chapter 9. Other Operating Expenditures

Chapter Conclusions

The agency's internal controls provided reasonable assurance that other operating expenditures were accurately reported in the accounting records, adequately safeguarded, and in compliance with applicable legal provisions and management's authorization. For the items tested, the agency complied with the significant finance-related legal provisions concerning the areas reviewed. However, the agency did not adequately monitor employee cell phone use.

The Iron Range Resources and Rehabilitation Agency spent approximately $19.8 million during the audit period for nonpayroll expenditures for its general operations and operating costs of Giants Ridge Golf & Ski Resort and Ironworld. These other operating expenditures included professional/ technical contracts, supplies and equipment, building and land improvements, employee travel expenditures, and other operating costs. (Payroll expenditures are discussed in Chapter 8, and grant and loan expenditures are discussed in Chapters 4 and 5.) Individual departments submitted requisitions for purchases, and the purchasing department would issue purchase orders to the vendors. A central receiving unit received the goods and signed the packing slip. The accounting department matched the packing slip to the invoice and made the payments.

Table 9-1 summarizes the payments for operating expenditures for the three years ended June 30, 2001.

Table 9-1
Summary of Expenditures
By Budget Fiscal Year

Expenditures	1999	2000	2001
Professional/Technical Services	$2,550,447	$3,175,660	$2,987,067
Building and Land Improvements	1,350,498	684,070	764,353
Supplies	784,357	781,188	834,848
Equipment	351,005	670,930	368,744
Other Operating Costs	651,560	2,809,826	1,090,170
Total Expenditures	**$5,687,868**	**$8,121,675**	**$6,045,182**

Source: Minnesota Accounting and Procurement System.

Iron Range Resources and Rehabilitation Agency

Audit Objectives and Methodology

We focused on the following objectives during our audit of other operating expenditures:

- Did the agency's internal controls provide reasonable assurance that the expenditure areas were accurately reported in the accounting records, adequately safeguarded, and in compliance with applicable legal provisions and management's authorization?
- For the items tested, did the agency comply, in all material respects, with the significant finance-related legal provisions concerning the expenditure areas?

To address these objectives, we completed an analytical review of other operating expenditures by type and investigated any unusual trends and amounts. We reviewed internal controls over the purchasing and receiving of goods and services and recording of expenditures on the accounting system. We tested a sample of expenditures for each of the material areas within the audit scope. We also tested compliance with finance-related legal requirements.

Conclusions

The agency's internal controls provided reasonable assurance that other operating expenditures were accurately reported in the accounting records, adequately safeguarded, and in compliance with applicable legal provisions and management's authorization. For the items tested, the agency complied with the significant finance-related legal provisions concerning the areas reviewed. However, the agency did not adequately monitor employee cell phone use.

17. The agency did not adequately monitor employee use of cell phones.

An agency review of a former employee's cell phone bills totaling approximately $4,500 from November 2000 through April 2002 identified business related and personal calls. The agency contacted the employee to request repayment of the personal calls. To avoid any question of impropriety, the employee repaid the agency for all cell phone charges, including any portion related to personal use.

When the agency provided cell phones to certain high-level staff, it should have established a process to monitor and review cell phone usage. Statutes allow employees to use state-owned equipment for personal use, provided this use results in no incremental cost to the state. State policies require that employees review and verify their cell phone billings, and that managers and supervisors monitor and review the billings on a monthly basis to ensure proper employee usage and cost-effectiveness, and to approve the bill for payment. Agencies must require reimbursement from employees for personal cell phone use that results in additional cost to the state.

Recommendation

- *The agency should establish and review cell phone bills each month to ensure compliance with state policy.*

Status of Prior Audit Issues
As of May 24, 2002

Legislative Audit Report 98-61, issued in October 1998, covered the three fiscal years ending June 30, 1998. The audit scope included Ironworld and Giants Ridge operations, taconite production tax revenue, and loans. In that audit, we found that the agency did not resolve the differences between its record of outstanding loan balances and the balances recorded on the state's accounting system. We also found that the managing firm for the restaurant offered employees a ten percent discount for meals. Finally, we noted that the agency did not verify the gross receipts of the Ironworld gift shop. The agency has resolved all three of the previous issues.

State of Minnesota Audit Follow-Up Process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up on issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota and quasi-state organizations, such as the Minnesota Historical Society, or the metropolitan agencies, or the State Agricultural Society, the state constitutional officers, or the judicial branch.

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Auditor's Comments on IRRRA's Response

Senator Ann H. Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Senator David Tomassoni, Chairman
Iron Range Resources and Rehabilitation Board

Members of the Iron Range Resources and Rehabilitation Board

Mr. John Swift, Commissioner
Iron Range Resources and Rehabilitation Agency

In its response to the audit report, the Iron Range Resources and Rehabilitation Agency included information that requires further clarification.

Finding 1 identified the need for the agency to reach an agreement with the board about its level of authority to act without direct board authorization. In its response, the agency stated that it feels that it has a clear understanding of its authority. While that may be true, ambiguity in the law combined with changes on the board and among agency staff may result in a conflict in the future. In fact, questions of whether the agency acted within its authority have arisen in the past, and resolution of those questions has been difficult to determine because the law is unclear.

Finding 2 suggested that the agency and the board develop conflict of interest policies that relate to the unique conflicts that they may face. The agency responded that it already has a more detailed conflict of interest policy for staff, and that the board adopted a policy. The agency located these policies after the audit exit conference. Staff and board members were not aware of these policies, and they were not in effect during the audit period.

Finding 3 discussed weak controls over access to the personnel/payroll and accounting systems. The finding relates to the access granted to staff to perform certain transactions on the computerized systems. In its response, the agency provides an explanation of its personnel and payroll process and cites various authorizations required before staff process personnel changes or enter payroll transactions. However, the computer access the agency has granted to certain staff allows them to perform incompatible duties regardless of any authorizations the agency may require.

Finding 4 questioned the agency's authority to provide $2.25 million to a venture capital fund without obtaining an equity interest in that fund and without charging interest, provided the fund

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meets certain investment requirements. In its response, the agency defends the area's need for venture capital funds and provides a recap of the benefit these funds have provided to the taconite tax relief area. The finding, however, was directed to the form of the transaction being neither an equity investment in a venture capital fund, nor a loan transaction that complies with statutory provisions, nor an "other form of participation," since the participation was prospective rather than current.

Finding 5 continued with additional concerns about the agency's lack of oversight over the venture capital fund's use of the agency's funds. In its response, the agency states that it never intended that the venture capital fund would solely use the funds for equity investments, and that the payment of management fees was implied as a standard practice in the venture capital industry. As stated in the audit report, the financing agreements that the agency and the venture capital fund representatives signed stated that the venture capital fund "will apply the entirety of the Financial Assistance proceeds to performance of the Project and will not use such proceeds for any other purpose not provided herein." The agreement defined the project as the commitment of the venture capital fund "to use the Financial Assistance proceeds, in conjunction with funds obtained from other sources of funding, to capitalize a fund . . . from which equity investments will be made." The written agreement takes precedence over the agency's intentions. The agency also suggests that the meaning of an "equity investment" is subject to interpretation. Equity, however, signifies an ownership interest of some type. Providing loans to an entity does not establish an equity interest.

Finding 7 questioned several aspects of the agency's use of a suite at the Excel Energy Center. One part of the finding noted that the agency held several events at the center before signing a contract. In its response, the agency states that it did not encumber or expend funds before executing the contract. However, it did incur liabilities for which the Excel Energy Center could have held it responsible.

In response to another part of Finding 7, the agency states that it does appropriately use special expense forms internally. However, agency staff had prepared a special expense form for only one of the seven events the agency held at the Excel Energy Center, and that form did not accurately state the catering costs or staff authorized to attend the event. In the case of the events held at the Excel Energy Center, we cannot agree that the agency used them appropriately.

Finally, as explained in Finding 8, the agency provided a loan to a business even though, subsequent to the board's authorization, the business' financial statements showed it to be in a significantly more dire financial situation. In their response, the agency identifies this particular case as a "workout" situation that required immediate action that could not wait for a board meeting to be scheduled. The agency has not provided any policy, procedure, or board resolution that allows it to act with greater authority in a "workout" situation than it would have in any other situation.

/s/ James R. Nobles	*/s/ Claudia J. Gudvangen*
James R. Nobles Legislative Auditor	Claudia J. Gudvangen, CPA Deputy Legislative Auditor

IRON RANGE RESOURCES & REHABILITATION BOARD

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October 15, 2002

Mr. James Nobles
Legislative Auditor
Office of the Legislative Auditor
Centennial Building
658 Cedar Street
St. Paul, MN 55155

Dear Mr. Nobles:

The following is the IRRRAs response to the FY1999 – 2001 audit findings as presented and discussed by the Office of the Legislative Auditor on September 24, 2002.

1. Statutory provisions do not clearly define the respective authorities of the board and the agency.

Recommendation

- *The agency and the board need to seek legislative clarification of statutory provisions defining those actions that can be initiated by the agency and those that require specific board approval.*

Agency Response

- The agency feels that it has a clear understanding of its authority. More specifically, any funds to be expended must be approved by the IRRR Board at some point in the process prior to actual expenditure. In the case of the Lodge at Giants Ridge cited in the report, no funds were expended that had not been approved by the board. Funds expended on the project had been approved either specifically for the project or generally as funds for capital investment in agency facilities. When the developer was unable to perform in selling ownership shares to third parties, the agency acted defensively to protect the project and the significant public dollars already invested. Further delineation of agency versus board roles raises possible constitutional "separation of powers" questions. The potential debate over that question would surely distract the agency away from its primary mission of economic diversification and job creation.

2. **The Iron Range Resources and Rehabilitation Agency does not have a conflict of interest policy that addresses the unique conflicts that its employees and board may face.**

Recommendation

- *The agency and the board should design conflict of interest policies that recognize their unique roles in the community and the impact that actual or suspected preferential treatment may have to its integrity.*

Agency Response

- All state employees are subject to the Code of Ethics M.S. Section 43 A.38. In addition, the IRRR Agency already has a more detailed conflict of interest policy with specific guidelines and steps for employees to take when confronted with a potential conflict of interest situation. The agency will redistribute the policy to remind employees of their responsibilities regarding potential conflicts of interest. The agency feels it is also reasonable to remind employees of the policy from time to time, as deemed appropriate. The IRRR Agency Human Resources Department may distribute the policy annually, for example. The agency does not feel additional policies are necessary.

  The IRRR Board has an existing conflict of interest policy adopted October 28, 1985, which addresses the concerns expressed in the audit. In addition, all board members were sent a memorandum in October 1994, detailing what was at that time the new, *Ethics in Government Act*. The agency will send these materials, if approved by the board chairperson, to all current board members as a reminder of the policies.

3. **The agency did not adequately restrict access to its accounting system.**

- Seventeen of the twenty employees with update access to the state's accounting system had the ability to both initiate a purchase and to disburse funds to pay for the purchase. These are generally considered to be incompatible duties between different employees.

- One of seven employees with access to the state's personnel/payroll system had access to all human resources and payroll functions on the system. An individual with this dual access could perform unauthorized personnel duties, such as setting up a fictitious employee or changing a pay rate, and then conceal the fraud when processing payroll transactions.

Recommendation

- *The agency should restrict system access to only those employees who require the access to perform their job functions. Whenever possible, access to all systems should be designed to maintain a proper separation of duties between accounting functions.*

Agency Response

- The IRRR Agency conducts business operations at three distinct locations, its administrative headquarters near Eveleth, Ironworld in Chisholm, and Giants Ridge near Biwabik. While the agency has consolidated some activities in the Eveleth office to reduce the number of employees requiring access to procurement and accounting systems, the separate locations nonetheless require more staff with access than would be required at a single site. The report acknowledges that the agency annually makes between 7,500 and 10,000 non-payroll disbursements each fiscal year. It also noted on page 7, "significant revenue reductions will challenge the agency to reduce operational costs". If the agency restricted access to the degree suggested in the report, it would be unable to complete the number of transactions required without increasing staff and associated costs. Notwithstanding access to computer software, further restrictions such as limited purchasing authority also serve to prevent abuse. No less than two people (one of them a budget manager) are required to complete any transaction. A budget manager's written approval (signature) is required for payment of any transaction. Monthly budget and expense statements are sent to managers for review and for explanation of variances as a further safeguard. Two (2) staff with access to the accounting system have left the agency and their computer security profiles have been deleted. There also has been a reduction in access by eight (8) staff, due to a change in duties or assignments. The agency believes adequate controls and separation of duties exist to retain remaining staff security profiles as is.

Recommendation

- *Where the elimination of any incompatible access to the accounting systems is not possible or impractical, the agency should design mitigating controls that would independently monitor the risks posed by such incompatible access.*

Agency Response

- Again, agency size and financial resources restrict its ability to completely separate all Human Resource duties. One might infer from the audit report that one individual creates new positions, appoints new employees, processes all time reports, enters payroll and processes and enters all pay increases. This is not the case. Establishment of new, permanent positions are processed by the Human Resource Director and the Department of Employee Relations in St. Paul with prior approval from the Commissioner or Deputy Commissioner. The Human Resource Director also processes appointments and establishes pay rates of permanent employees after the interview process, employment/background verification, etc. An agency interview committee conducts the interview process. The Commissioner or Deputy

Commissioner approves all appointments and pay rates. The same process is followed on the reclassification of permanent agency employees. After this process is complete, the Human Resource Director forwards the information to the Personnel Officer, Senior, who in turn makes a record in the Personnel Record Book, Personnel File, Agency Roster, etc. The Personnel Officer then enters the information into the State's personnel/payroll system. All backpay transactions are calculated and compiled by the Personnel Officer, Senior, documented and approved by the Human Resource Director. The Personnel Officer then enters these backpay transactions.

The process for temporary employees is handled a bit differently. When a temporary employee is required, managers submit a request to the Human Resource Director outlining their needs. Such a request first must comply with the appropriate budget. Depending upon the request, the Human Resource Director may make an independent decision or may request approval of the Commissioner or Deputy Commissioner. Typically, the Human Resource Director will independently approve the appointment of student workers, interns and temporary laborers. Temporary employees, such as office and administrative support positions, professional positions, etc. are approved by the Commissioner or Deputy Commissioner. Upon approval, the Human Resource Director will forward the position paperwork to the Personnel Officer for entry into the state's personnel/payroll system.

Regarding actual payroll entry, time reports first are submitted to the Human Resource office. The Personnel Officer and Personnel Officer, Senior, then review time reports to insure that all timesheets and leave slips have been properly authorized and are consistent with each other. Payroll entry is usually done by the Personnel Officer, however, the Personnel Officer, Senior, enters payroll from time to time. Labor distribution is entered during the week following payroll entry. Labor distribution is entered by either the Personnel Officer or Personnel Officer, Senior. The audit report indicates that "no one independent of these duties reviews the personnel output for errors." This is not true, since the Agency Accounting Officer, Senior, receives a payroll audit report bi-weekly. He in turn generates a budget report from this data. Division Managers receive a payroll audit report from the Accounting Division on a monthly basis, but no signature approval has thus far been required. The Human Resource Director regularly reviews payroll rosters and audit reports to update complement rosters, full-time equivalency numbers, etc.

The process IRRRA has in place provides adequate internal controls. To reinforce these controls, however, the agency has taken the following steps:

1) The Agency Accounting Division will send a payroll audit report to each manager for his/her respective division on a bi-weekly basis. The report shall be reviewed and approved by each manager on a bi-weekly basis.
2) A payroll audit report reflecting all agency transactions will be provided to the Agency Human Resource Director on a bi-weekly basis. The report shall be reviewed and approved by the Human Resource Director on a bi-weekly basis.
3) Every effort will be made to separate the actual payroll entry from the labor distribution entry so that the Personnel Officer and the Personnel Officer, Senior, will be entering one or the other on a bi-weekly basis. This will provide another crosscheck and further ensure internal control.

In reference to item 3 above, every effort will be made to separate these duties. However, from time to time this may be a problem due to vacations, sick leave, etc. Also, the agency needs to take in to consideration that these employees are responsible for many other functions within the Human Resource Division. Examples of these functions include safety functions, employee benefits, labor relations, workers compensation, affirmative action, etc.

4. The agency's interpretation and application on the statutory administrative cost limitations may not comply with legislative intent.

Recommendation

- *The agency should obtain legislative clarification of the administrative cost limitations to ensure that its interpretations of these limitations satisfy legislative intent.*

Agency Response

- The agency has a long and consistent history of its assignment of "administrative costs" in its financial records. Consistent reporting over time, within the scope of statutory provisions and generally accepted accounting principles, is a basic tenet of financial reporting. The agency does believe, however, that existing statutory language is archaic and may be confusing to some individuals. Accordingly, it intends to seek legislative clarification to avoid any potential confusion in the future.

5. The agency's transactions with a venture capital fund may not have been an authorized use of the Northeast Minnesota Economic Protection Trust Fund.

- "To invest in a venture capital fund or enterprise that will provide capital to other entities that are engaging in, or that will engage in, projects or programs that have the purposes set forth in subdivision 1." An investment normally results in some form of equity ownership and an expectation of a return on the investment.

- "To provide loans, loan guarantees, interest buy-downs, and other forms of participation with private sources of financing." The agency has interpreted "other forms of participation" to include awarding grants.

Recommendation

- *The agency should only use Northeast Minnesota Economic Protection Trust Funds as allowed by statutory authority.*

Agency Response

- The agency does not believe the audit report accurately reflects the situation relative to investment of agency dollars in a regional equity fund. The formation and capitalization of this fund was extremely important in the development of a complete suite of financing options for northeastern Minnesota businesses. The region had a critical need for venture financing for emerging growth and start-up companies.

  All three investments in Iron Range Ventures (IRV) were legal and authorized uses of Northeast Minnesota Economic Protection Fund (NEPF) monies. The draft report acknowledges the statutory authority for the agency to expend funding in "… other forms of participation with private sources of financing." While the IRRR Agency made investments in IRV, it is very clear from the documents that IRRRA participation also was intended to lever funds from IRV's parent - Northeast Ventures (NEV). Prior to the first project with IRV, NEV had raised $7.7 million to capitalize its fund from various public and private partners. Subsequent to the agency's 1996 agreement, NEV raised a total of $4.25 million in additional funds and IRV raised an additional $1.524 million in funds from outside sources. In fact, the funds from the 1996 and 1997 IRRR agreements were used directly as a "match" which allowed NEV to receive $1.25 million in Community Development Financial Institute (CDFI) funds that were awarded in April 1997 and funds from the 1999 agreement were again used as a direct "match" that allowed IRV to receive $1 million in CDFI monies that were awarded in April 2001. Audit staff has previously been provided with this documentation. The link between IRV and NEV is undeniable, as NEV is the sole member of IRV and the organizations have the same CEO and Board of Directors. All three agreements were drafted and executed by the office of the Attorney General.

  The transactions provided and continue to provide companies in the Taconite Tax Relief Area (TTRA) greater access to needed venture capital funds. The monies have provided and will continue to provide a very clear benefit to the TTRA. It long has been understood that the lack of available venture capital in our relatively remote region has been a hindrance to the growth of area companies. Funds from the IRRR Agency were directly matched with CDFI monies that otherwise would not have flowed to the area, and provided a critical component in raising, to date, over $15 million in aggregate between NEV and IRV. To satisfy the terms of the agreements, IRV and NEV are required to invest in aggregate a total of $7 million in equity investments in the TTRA. Since the first IRRRA assistance was funded through the second quarter of 2002, IRV and NEV made equity investments of over $2.5 million in ten companies within the TTRA. NEV and IRV also have provided other means of financial assistance to these companies that have been critical to their growth and viability. As of June 2002, these ten companies employed a total of 242 people in the TTRA.

  The IRRR Agency firmly believes that the transactions to provide financial assistance to IRV were legal and authorized uses of NEPF monies. IRV has shown a very clear and identifiable benefit to the TTRA.

6. The agency did not adequately monitor the venture capital fund's use of Northeast Minnesota Economic Protection Trust Funds nor curtail certain financial activity that did not comply with the financing agreement or statutes.

- The schedule of portfolio investments in the financial report for December 31, 1999, and the Quarterly Report for the quarter ended December 31, 1999, showed that investments made by the venture capital fund through December 31, 1998, totaled $292,000, although it had received $1 million from the agency in 1996 and $250,000 in 1997. (During 1998, the fund wrote off $142,000 of that investment as a realized loss.)

- The quarterly investment reports identified some of the fund's investments as frequently recurring, working capital loans to a business rather than as equity investments.

- The December 31, 2001, financial report showed a $382,711 notes receivable that a footnote explained as: "Notes receivable consist of short-term advances to portfolio investment companies. The notes, which are due on demand, bear interest at 15 – 18 percent."

- Footnotes to the financial reports disclosed that the venture capital fund paid its parent corporation a management fee. In fiscal years 1999, 2000, and 2001, those fees totaled $72,000, $144,000, and $198,000 respectively. The reports also identified incentive compensation of $10,453, $4,666, and $73,296 for those same periods. The financial assistance agreements do not address the payment of a management fee.

- The December 31, 2001, financial report's Schedule of Portfolio Investments included a $750,000 investment that the venture capital fund did not list on its quarterly investment reports.

Recommendation

- *The agency should monitor and review the financial activity of the venture capital fund and ensure that it used the $2.25 million in accordance with the financing agreements.*

Agency Response

- The IRRR Agency believes that it has adequately monitored the use of its funds and that the funds have been used by Iron Range Ventures (IRV) in complete compliance with the agreements. The audit report is correct in that all agreements between the IRRRA and IRV stated that the project was "to use the Financial Assistance proceeds, in conjunction with other sources of funding, to capitalize a fund … from which equity investments will be made" in for profit businesses located in the Taconite Tax Relief Area (TTRA). It was never intended, nor do the agreements specify, that making equity investments would be the sole use of the fund. To satisfy the terms of

the agreement and to not have to refund any IRRRA monies, IRV and NEV in aggregate are required to invest a total of $7 million in equity in qualified companies. IRV did not, in any way, commit to solely using the funds to make equity investments and this was neither expected nor anticipated by the IRRRA in entering into the agreements. It is standard practice in the venture capital industry to use other forms of financing in addition to equity investments to stimulate business growth.

It was never anticipated that IRV and NEV would invest the monies received from the IRRRA in a very short period of time. It was always expected that it would take years for IRV to satisfy the investment covenants in the agreements as evidenced by the "trigger dates" – 15 years from closing for the '96 and '99 agreements and five years from closing for the '97 agreement. The agency was certainly aware that all of its investment covenants from prior agreements were not yet satisfied when the decisions were made to make subsequent investments. IRRRA investments were primarily intended as a local match for IRV and NEV in their efforts to lever sources of funds from outside the TTRA. In order to succeed, a venture capital firm must look at many investment opportunities before choosing to invest in a particular company. Identifying the right prospects and agreeing to the proper structure of the investment is a very complex process. These opportunities to invest can be even harder to find in an area that has historically suffered from a lack of available venture capital.

As mentioned previously, it was neither intended nor stipulated that IRRRA funds be used solely for making equity investments. Typically, companies that are seeking venture capital investment have limited options for alternative sources of financing. The venture firm becomes a partner in the truest sense and quite often is the only option as a source of funding should additional cash needs arise. While these subsequent investments may come in the form of additional equity, many situations (for a variety of reasons) dictate that the assistance be provided more effectively by other means. IRV did request that the IRRRA consider companies financed by other than equity investments be counted toward satisfaction of its "investment covenants." IRV has since agreed with the IRRRA position that only equity investment in the strictest sense would be counted toward satisfying the covenants. It is important to note that through the second calendar quarter of 2002, equity investments in qualified companies exceeds the aggregate amount of IRRRA assistance.

It is also standard practice in the venture capital industry to pay fees to manage a fund. The IRRRA does not believe that the fees paid by IRV to its parent NEV are in any way exorbitant or extraordinary compared to typical fees paid within the industry. The agreements between the IRRRA and IRV do not preclude the payment of a management fee or other administrative costs. In 2001, IRV purchased stock in a company from its parent for $500,000. This asset is listed on the audited statements of IRV as of December 31, 2001, but has not been listed on the quarterly investment reports submitted by IRV to the IRRRA as the investment is in a company located outside of the TTRA. Nothing in the IRRRA agreements precludes IRV from investing in out-of-area companies. This investment has not been listed in IRV's reports to the agency, as it will not count toward satisfying the investment covenants of the agreements.

IRV has complied with all requirements of the respective agreements, with compliance being carefully monitored by agency staff. However, an amendment will be added to our current agreement that specifically deals with the correct definition of the term "equity" and also identifies allowable expenditures of IRRRA grant dollars.

7. The agency incurred questionable or excessive costs in its sponsorship of a suite at the Excel Energy Center.

Recommendation

- *The agency should not incur liabilities or encumber funds until it fully executes a contract*

Agency Response

- The agency is aware of this provision and follows this rule. However, as a practical matter, time does not stand still for administrative processes. In this case, the board had approved the expenditure of funds for the contract and plans for use of facilities were proceeding in anticipation of contract execution. An unexpected illness in the Attorney General's staff extended the timeline for execution of this contract by an unknown amount of time. No funds were encumbered or expended prior to contract execution, in keeping with state statutes. The agency fully intends to continue to comply with statutory provisions and administrative policies.

Recommendation

- *The agency should ensure and document that any disbursement it makes serves a public purpose and provides its primary benefit to the taconite tax relief area.*

Agency Response

- The annual cost of the sponsorship agreement to the agency was $98,000. This was an excellent value for the Taconite Tax Relief Area (TTRA) as it relates to the agency's mission of economic diversification of the region. For example, while the sponsorship agreement called for the equivalent of 88 one-minute radio advertisements worth $795 each, it actually received 151 one-minute advertisements worth $795 each or $120,045. The Iron Range Grill in the Excel Energy Center was also part of the sponsorship, which allowed the agency to place business promotional materials about the TTRA and the agency in the restaurant. The sponsorship agreement was primarily implemented as a marketing and sales tool for recruiting new businesses to the TTRA. During events at the Center over 60 business contacts were made. Some examples of beneficial contacts include: Belcorp Industries – 19 jobs; Anderberg Communications – 18 jobs; Blue Cross Blue Shield – 200 jobs; Entronix, Inc. – 100 jobs; Teck-Cominco – 1,000 potential jobs. It is clear that there has been a definite economic benefit to the TTRA through this arrangement.

Recommendation

- *The agency should follow the state's special expense policies when it anticipated incurring expenditure that exceeds amounts allowed under regular state expense guidelines.*

Agency Response

- Management was unaware of the need to submit special expense plans to the Department of Employee Relations. It is apparent that agency staff had submitted forms in the past, since one was submitted in 1997, as pointed out in the audit report. Staff turnover most likely played a part in this oversight. The agency does appropriately use special expense forms internally. It is the intention of the agency to comply with this policy for exceptions to typical state employee expense limitations.

Recommendation

- *The agency and the board should develop a policy to define the reasonable and allowable expenses it can incur under the new legislation.*

Agency Response

- The agency is aware of the potential for misunderstanding as well as misperception that could result from less than judicious use of the new legislation. The agency has a "draft" policy, but more definitive work will be completed prior to full implementation. The IRRR Agency has contacted the Office of Tourism to review elements of a similar policy it has in place. Once a comprehensive policy is drafted, it is the Commissioner's intent to review it with the IRRR Board prior to implementation.

8. **The agency issued a loan to a business to refinance existing debt, which agency loan guidelines prohibit. In addition, the agency did not reconsider the issuance of the loan after receiving audited financial statements that showed a significantly poorer financial position than that presented in the business loan application.**

Recommendation

- *The agency should follow its loan guidelines and document the reasons for any deviations from the guidelines.*

Agency Response

- IRRR Agency has a goal of strengthening and diversifying our regional economy. In pursuit of this goal, the agency tries to assist in the creation of new employment opportunities and to retain existing jobs. As a majority of new jobs come from the expansion of existing businesses, the agency has developed and implemented many different programs with different guidelines. The guidelines enable the agency to

deal specifically with certain projects. It must be emphasized, however, that the guidelines are just that. They provide basic parameters for implementing and administering programs, but are not meant to be inflexible.

The project referred to in the audit regarding refinancing was a local manufacturing company that was experiencing financial difficulties and was in jeopardy of closing. The closing of this facility would have meant a significant loss of jobs in our area. This project was categorized as a workout situation and the agency's financial involvement was meant to assist in saving the business and jobs. The importance of keeping this business and maintaining the associated jobs made it necessary to deviate from the agency's guidelines. The agency financial team, the Technical Advisory Committee, Commissioner, and Board all agreed that the agency should proceed with the project.

Occasionally, the agency chooses to deviate from its guidelines to deal with unique projects that require special consideration. However, any future deviation from the guidelines will be noted in the file and during the approval process.

Recommendation

- *The agency should consider the most accurate and timely financial information from loan applicants and submit accurate and timely information to the board.*

Agency Response

- When reviewing financial statements and other information, agency loan officers always request the most recent information available. The instance cited in the audit report involved the above project. The prior explanation discusses why the agency determined that the circumstances warranted deviation from its standard operating guidelines. In this case a decision was necessary before the agency could obtain audited financial statements.

  In a "workout" situation, unless additional new monies are requested, it has been the long-standing practice of the agency not to seek further board approval of actions taken to achieve "workout" goals.

  Workout projects often demand immediate action, which cannot wait for the scheduling of board meetings. In the business world, such a delay might well result in further injury to the business, which could actually compromise the agency's security interest in a project.

  The agency will continue to request the most current financial information available.

9. The agency did not reconcile the daily cash receipt log to the bank deposit records.

Recommendation

- *The agency should assign an independent staff person to periodically reconcile the check log to the deposit records.*

Agency Response

- The IRRR Agency implemented a policy on September 12, 2002, that calls for no less than 4 spot audits per month by an independent accounting staff member.

10. The agency's process for selecting grant projects needs improvement.

Recommendation

- *The agency needs to work with the board to develop grant ranking guidelines that ensure that it awards grants objectively to projects that further the agency's mission.*

Agency Response

- The agency agrees that its grant selection criteria could be improved. The development team manager is in the process of developing selection criteria for commissioner review and approval. Upon commissioner approval, these criteria will be submitted to the board for its review.

11. The agency did not comply with retainage requirements mandated in some grant contracts.

Recommendations

- *The agency should improve its grant monitoring process to ensure it does not disburse money before the grantee meets the goals of the grant project and has submitted final accounting reports.*

- *The agency should develop a checklist that it can use to track the grant information required before the disbursement of grant funds.*

Agency Response

- While the agency concurs with audit findings regarding improvements in the grant process, it must be pointed out that not all grants fall into the same category. It may be appropriate to have retainage in some grant contracts, but not in others. It also must be pointed out that certain budgeted dollars approved by the board for use at the commissioner's discretion may not have specific guidelines, however projects funded from this allocation are consistent with the agency mission and laws that govern the use of agency funds.

The development team manager has scheduled meetings to establish clear direction on all development type grants. Other grant forms will be developed with clear and specific information required for each grant type. The appropriate statutes will be included with individual reporting criteria. A tracking process for all grants will be developed along with the appropriate information checklists for each type of grant.

12. The agency improperly issued grants for professional and technical services.

- The vendor received over $53,000 to help sponsor services for the Governor's Golf Challenge event.
- The vendor received $5,800 to help the agency complete a loan application with the U.S. Department of Agriculture.
- The vendor used grant funds to schedule speakers for training seminars and for a variety of other special marketing and recruitment initiatives.

Recommendation

- *The agency should comply with statutory regulations and issue contracts for professional and technical services.*

Agency Response

- The Governor's Golf Challenge was a public/private partnership between the Iron Range Resources and Rehabilitation Agency (IRRRA) and several other partners, primarily from the private sector. These private sector partners contributed over $30,000 toward the event. These event co-sponsors included Delta Dental, Minnesota Power, Entronix International, the Fryberger law firm from Duluth, Kraus-Anderson Construction Company and True North (a MNSCU initiative). Because of this unique mix of partners, it was determined, early on, that the most efficient way to manage the funds being contributed, with the financial obligations being incurred, was to secure the assistance of a neutral third party which could serve as fiscal agent for the event. The third party agreed to by all of the contributors to serve as fiscal agent (vendor) was a private sector non-profit economic development organization headquartered in Duluth. At the request of the public/private partners, the vendor secured commitments for golfing, food, rooms, etc. and then paid the bills as they came due. Oversight of this activity was provided for by agency staff. Funds were carefully segregated into two accounts to ensure that public resources were only utilized for activities consistent with state expense guidelines and that the private sector monies were applied to expenditures that were more appropriate to them, such as refreshments and gifts.

  The event was a resounding success and led to the development of several business recruitment relationships that continue to pay dividends to the Taconite Tax Relief Area. It provided the agency with an opportunity to significantly leverage some of its business recruitment funds by attracting significant financial partnering from the private sector.

- The IRRR Agency engaged the services of a not-for-profit agency, which is highly experienced in the application process for federal programs and is very successful in obtaining federal dollars. The application timeline for submission was quite short and it was determined that no IRRR Agency staff member had the experience required to complete the application by the deadline. In view of the revenue challenges the agency faces, as noted in the audit, and the closure of LTV Steel Mining Company, the agency proceeded with a sense of urgency and without intent to circumvent the state's procurement process. In short, the focus of the team that made the decision was not procurement issues.

  The materiality of the $5,800 expenditure must be weighed against the fact that the agency was successful in obtaining $750,000 in federal funds for fiscal 2003 and potentially $15 million over 20 years. This money will be used for business development/job creation projects in the Taconite Tax Relief Area, so this project actually does benefit third parties over many years.

- The Iron Range Economic Alliance (IREA) is an organization of elected officials and economic development professionals from communities and organizations across the Iron Range. It receives limited funding from the IRRRA and, from time to time, works very diligently to leverage that funding with outside funding from public/private partnerships whenever possible for special marketing and recruitment initiatives or other special projects. One such occurrence was in the fall of 1998, when the Iron Range Economic Alliance pooled $2,000 from its meager budget with funds it generated from several other partners to host an economic development seminar on the Iron Range entitled "The Competitive Advantage: How It Can Work for Your Economic Development Program." Other partners included the Range Association of Municipalities and Schools (RAMS) organization, Minnesota Power, the United Power Association and the RLK Kuusisto engineering and consulting firm. The money from these sponsors was pooled and placed with a private sector non-profit organization, which served as fiscal agent for the partnering sponsors. Two main speakers were brought in, who were recognized nationally as being experts in their fields, to conduct the seminar. One was from Montreal, Quebec, Canada, and the other from Massachusetts. The speakers' fees, transportation, lodging as well as facility rental costs and noon lunches were paid out of the funds that were pooled. In addition the president of the Minnesota High Technology Association flew to the Iron Range at his own expense to make an afternoon presentation on the role technology could play in the region's future. Total cost for the event was approximately $8,000, with the IREA successfully leveraging its funds by four-to-one.

  The agency understands the importance of procurement guidelines and will strive to improve its application of the appropriate contract vehicle to use relative to the procurement process, urgency factors notwithstanding.

13. The agency had some weak controls over the receipt process and did not always timely deposit or record receipts.

Recommendation

- *The agency should separate the incompatible duties of collecting, recording, and depositing receipts. If separation of these duties is not possible, the agency should implement adequate procedures, such as a timely review of documentation supporting receipt transactions, to detect an error or irregularity.*

Agency Response

- The nature of Ironworld's operation results in its requiring an annual subsidy of ranging from $1.5 million to $1.8 million of IRRRA funds. The agency acknowledges the importance of separation of duties and/or adequate accounting procedures. However, given the IRRR Agency's financial challenges, maximum expense reduction is a priority at all sites. This recommendation assumes the employment of at least two people to complete tasks on a daily basis, which is questionable from a budget standpoint.

Recommendation

- *The agency should ensure that it maintains documentation to support its receipt transactions.*

Agency Response

- The agency has, since fiscal year 2001, installed and/or upgraded Point of Sales (POS) hardware and software to assist with documenting receipt transactions. Each transaction will be documented through this computerized system.

Recommendation

- *The agency should deposit receipts as required by statute and promptly record receipt transactions on the state's accounting system.*

Agency Response

- Deposit of receipts during Ironworld's "off season" continues to be a cost/benefit challenge. Many weeks the deposit does not reach the $250 deposit threshold. Ironworld staff does lock daily receipts in an on-site safe. It is costly, impractical, and inefficient to use staff that is already stretched thin to travel to the bank to make deposits less than the statutorily required minimum of $250. Receipt transactions may only be recorded at the time of actual deposit, therefore entry must be delayed until a deposit is made at the bank.

In keeping with statutory requirements, Ironworld either will make daily deposits, deposits when receipts total $250 or more, or weekly deposits when receipts are less than $250.

14. The agency did not charge other agencies for archival services at Ironworld.

Recommendation

- *Ironworld should consider charging a fee for its archival services to recover the cost of providing this service.*

Agency Response

- Ironworld staff is currently looking into this possibility.

15. The agency did not adequately separate incompatible payroll and human resource duties.

Recommendation

- *The agency should separate incompatible human resource and payroll duties including establishing an independent verification of the hours reported on timesheets to the hours processed in the state's personnel/payroll system.*

Agency Response

(see second recommendation under issue #3, page 3)

- One might infer from the audit report that one individual creates new positions, appoints new employees, processes all time reports, enters payroll and processes and enters all pay increases. This is not the case. Establishment of new, permanent positions are processed by the Human Resource Director and the Department of Employee Relations in St. Paul with prior approval from the Commissioner or Deputy Commissioner. The Human Resource Director also processes appointments and establishes pay rates of permanent employees after the interview process, employment/background verification, etc. An agency interview committee conducts the interview process. The Commissioner or Deputy Commissioner approves all appointments and pay rates. The same process is followed on the reclassification of permanent agency employees. After this process is complete, the Human Resource Director forwards the information to the Personnel Officer, Senior, who in turn makes a record in the Personnel Record Book, Personnel File, Agency Roster, etc. The Personnel Officer then enters the information into the State's personnel/payroll system. All backpay transactions are calculated and compiled by the Personnel Officer, Senior, documented and approved by the Human Resource Director. The Personnel Officer then enters these backpay transactions.

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The process IRRRA has in place provides adequate internal controls. To reinforce these controls, however, the agency has taken the following steps:

4) The Agency Accounting Division will send a payroll audit report to each manager for his/her respective division on a bi-weekly basis. The report shall be reviewed and approved by each manager on a bi-weekly basis.
5) A payroll audit report reflecting all agency transactions will be provided to the Agency Human Resource Director on a bi-weekly basis. The report shall be reviewed and approved by the Human Resource Director on a bi-weekly basis.
6) Every effort will be made to separate the actual payroll entry from the labor distribution entry so that the Personnel Officer and the Personnel Officer, Senior, will be entering one or the other on a bi-weekly basis. This will provide another crosscheck and further ensure internal control.

In reference to item 3 above, every effort will be made to separate these duties. However, from time to time this may be a problem due to vacations, sick leave, etc. Also, the agency needs to take in to consideration that these employees are responsible for many other functions within the Human Resource Division. Examples of these functions include safety functions, employee benefits, labor relations, workers compensation, affirmative action, etc.

16. The human resources division did not adequately monitor vacant positions and staff working out of class.

Recommendation

- *The agency should more timely fill vacant positions and better monitor the status of employees working out of class.*

Agency Response

- Agency reorganization and restructuring, reduction in agency staffing and reassignments due to budget constraints are the primary reasons for the work out of class assignments. Changes in agency management and the DOER staffing division, as well as delays in position establishment and reclassification of unique positions are key factors in the excessive length of such appointments.

  In the future, when agency management determines the need to compensate an employee for a temporary reassignment, assuming additional duties and more complex responsibilities, it will work with the Department of Employee Relations to establish a temporary unclassified position. Since DOER will not establish temporary unclassified positions for AFSCME classifications, work out class assignments will have to be utilized from time to time in order to properly compensate AFSCME employees. These assignments will be carefully monitored by the Human Resources Division to ensure that appointments do not exceed the one-year limitation.

17. The agency did not adequately monitor employee use of cell phones.

Recommendation

- The agency should establish and review cell phone bills each month to ensure compliance with state policy.

Agency Response

- The nature of the agency's operation's results in many staff using cell phones regularly. The agency currently has twenty-five (25) cell phone accounts agency wide. Despite the number of cell phones, only one case of abuse was noted. Once discovered, the agency acted quickly to recover the dollars comprising the phone calls in question. The individual, who had previously left the agency for other employment, had made some reimbursement to the agency when the bills were originally received, and in fact ultimately paid the total amount of all cell phone bills in question, at his insistence.

  While it is impractical to have a limited staff review each cell phone bill in detail, the agency has instructed the accounts payable staff to review them for excessive charges or other "unusual" call patterns. However, consistent with Department of Finance Operating Policy and Procedure number 0807-04, it is the responsibility of managers and supervisors

to monitor and review cell phone bills of their staff. Copies of the policy have been sent to all managers and supervisors as a reminder of their role.

This concludes our response to the audit findings. We wish to thank the Office of the Legislative Auditor for their assistance and cooperation.

Sincerely,

/s/ John Swift

John Swift
Commissioner