

DEPARTMENT OF MILITARY AFFAIRS

FINANCIAL AUDIT

FOR THE YEAR ENDED JUNE 30, 1993

JUNE 1994

Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

94-27

DEPARTMENT OF MILITARY AFFAIRS

FINANCIAL AUDIT FOR THE YEAR ENDED JUNE 30, 1993

Public Release Date: June 17, 1994

No. 94-27

OBJECTIVES:

- **EVALUATE INTERNAL CONTROL STRUCTURE:** Military construction, Army and Air National Guard reimbursements (CFDA #12.00), payroll, state and federal administrative expenditures, and Minnesota State Armory Building Commission revenue and expenditures.
- **TEST COMPLIANCE WITH CERTAIN FINANCE-RELATED LEGAL PROVISIONS.**

CONCLUSIONS:

We found four weaknesses in the internal control structure:

- The Armory Building Commission's bank account is not collateralized for balances exceeding \$100,000.
- The Armory Building Commission is not monitoring for compliance with the federal arbitrage restriction and rebate requirements.
- The department overcompensated three National Guard members under the re-enlistment and tuition reimbursement programs.
- The department overpaid the Department of Natural Resources under an interagency agreement.

We found one departure from finance-related legal provisions:

- The department has entered into an employment relationship with a former employee contrary to Minn. Stat. Section 16B.17.

Contact the Financial Audit Division for additional information.

296-1730

FINANCIAL AUDIT DIVISION



STATE OF MINNESOTA

OFFICE OF THE LEGISLATIVE AUDITOR

CENTENNIAL BUILDING, ST. PAUL, MN 55155 • 612/296-4708

JAMES R. NOBLES, LEGISLATIVE AUDITOR

Senator Phil Riveness, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Major General Eugene Andreotti
Adjutant General
Department of Military Affairs

Audit Scope

We have conducted a financial related audit of the Minnesota Department of Military Affairs as of and for the year ended June 30, 1993. Our audit was limited to only that portion of the State of Minnesota financial activities attributable to the transactions of the Department of Military Affairs. We have also made a study and evaluation of the internal control structure of the Department of Military Affairs in effect at June, 1993.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial activities attributable to the transactions of the Department of Military Affairs are free of material misstatements.

As part of our study and evaluation of the internal control structure, we performed tests of the Minnesota Department of Military Affairs' compliance with certain provisions of laws, regulations, contracts, and grants. However, our objective was not to provide an opinion on overall compliance with such provisions.

Management Responsibilities

The management of the Minnesota Department of Military Affairs is responsible for establishing and maintaining an internal control structure. This responsibility includes compliance with applicable laws, regulations, contracts, and grants. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that:

- assets are safeguarded against loss from unauthorized use or disposition;
- transactions are executed in accordance with applicable legal and regulatory provisions, as well as management's authorization; and

- transactions are recorded properly on the statewide accounting system in accordance with Department of Finance policies and procedures.

Because of the inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

Internal Control Structure

For purposes of this report, we have classified the significant internal control structure policies and procedures in the following categories:

- military construction, Army and Air National Guard reimbursements (CFDA #12.000),
- state and federal administrative expenditures,
- payroll, and
- Minnesota State Armory Building Commission revenues and expenditures.

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we also assessed control risk.

Conclusions

Our study and evaluation disclosed the conditions discussed in findings 1, 2, 4, and 5, involving the internal control structure of the Minnesota Department of Military Affairs. We consider these conditions to be reportable conditions under the standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in financial statements.


A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial activities being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We do not believe the reportable conditions described above are material weaknesses.

Senator Phil Riveness, Chair
Members of the Legislative Audit Commission
Major General Eugene Andreotti, Adjutant General
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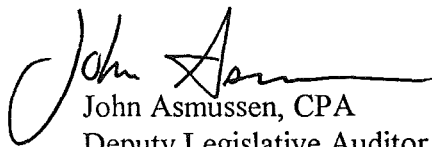
In addition, we noted other certain matters, involving the internal control structure and its operations that we reported to the management of Military Affairs at the exit conference held on May 12, 1994.

The results of our tests indicate that, except for the issues discussed in findings 2, 3, and 4, with respect to the items tested, the Minnesota Department of Military Affairs complied, in all material respects, with the provisions referred to in the audit scope paragraphs. With respect to items not tested, nothing came to our attention that caused us to believe that the Minnesota Department of Military Affairs had not complied, in all material respects, with those provisions.

This report is intended for the information of the Legislative Audit Commission and management of the Minnesota Department of Military Affairs. This restriction is not intended to limit the distribution of this report, which was released as a public document on June 17, 1994.



James R. Nobles
Legislative Auditor



John Asmussen, CPA
Deputy Legislative Auditor

End of Fieldwork: March 1, 1994

Report Signed On: June 10, 1994

Department of Military Affairs

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Audit Participation

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

John Asmussen, CPA	Deputy Legislative Auditor
Tom Donahue, CPA	Audit Manager
Janet Knox, CPA	Audit Supervisor
Christina Weiss	Audit Staff

Exit Conference

The findings and recommendations in this report were discussed with the following staff of the Department of Military Affairs on May 12, 1994:

Eugene Andreotti	Adjutant General
Thomas Ryan	Executive Director
Marlene Anderson	Accounting Supervisor
Gary Bloedel	Military Auditor
Terry Palmer	Executive Director, State Armory
	Building Commission

Introduction

The Department of Military Affairs consists of the military forces of the state of Minnesota, the Office of the Adjutant General, civilians employed for administration and maintenance, and state owned military installations. The Minnesota State Armory Building Commission is chartered as a corporation responsible for financing the construction of new National Guard armories, and maintaining those armories until the debt is retired and the property is transferred to the state. The Adjutant General serves as chair of the commission.

The Minnesota Army and Air National Guard are the organized militia of the State of Minnesota, under command of the Governor. The national guard is a reserve component of the active U.S. Army and Air Force, and may be called into federal service by the President of the United States. The Minnesota National Guard provides units that are organized, equipped, and trained to function efficiently at existing strength, in the protection of life and property and the preservation of peace, order and public safety under orders of the Governor. The federal mission of the guard is to augment the active Army and Air Force, providing units for mobilization in time of war or national emergency.

The Army National Guard operates 61 armories, 17 organizational maintenance shops, 5 motor vehicle storage buildings, the Camp Ripley Reservation, and an Army air base at the St. Paul downtown airport. The Air National Guard is stationed at a state owned air base in Duluth and at a federally owned and operated air base at the Minneapolis-St. Paul international airport.

The adjutant general, as military chief of staff to the Governor, heads the Department of Military Affairs and is responsible for the guard fulfilling its state and federal missions. The adjutant general accepts federal monies on behalf of the state for military forces and executes related agreements and contracts for armory construction, improvements, and maintenance programs. General Eugene R. Andreotti is the Adjutant General.

Department of Military Affairs

Table 1 summarizes the department's revenues and expenditures for fiscal year ended June 30, 1993.

Table 1
Department of Military Affairs
Revenues and Expenditures
Fiscal Year Ended June 30, 1993

Revenue

Military construction, Army and Air	
National Guard reimbursements (CFDA #12.000)	\$11,350,848
Minnesota State Armory Building Commission	3,670,092
Other	<u>210,537</u>
Revenue Total	<u>\$15,231,477</u>

Expenditures:

State administrative expenditures	\$ 4,912,759
Federal administrative expenditures	3,385,870
Payroll	12,965,801
Minnesota State Armory Building Commission	3,662,319
Other	<u>127,523</u>
Expenditure Total	<u>\$25,054,272</u>

Sources: Statewide Accounting System Estimated Actual Receipt and Manager's Financial Reports as of 9/3/93 and the Minnesota State Armory Building Commission's Cash Basis Financial Statements for the fiscal year ended June 30, 1993. Excludes expenditures paid for directly by U.S. Treasury.

Current Findings and Recommendations

- 1. The Minnesota State Armory Building Commission's bank account is not collateralized for balances exceeding the FDIC insured amount of \$100,000.**

The Commission has not required collateral be provided for its cash balances on deposit in excess of \$100,000. During the eighteen month period between July 1, 1992 and December 31, 1993, daily cash balances exceeding \$100,000 occurred 87 times. One balance exceeded the insured amount of \$100,000 by \$2,389,219.

As specified in the Commission's Corporation Charter and By-laws, the Commission maintains a single checking account, in a Commission designated bank, for all its receipts and withdrawals. The Charter does not address the requirement for collateral for deposits on hand, in excess of the FDIC insured amount of \$100,000. These funds are at risk of loss in the event of the bank's failure. It is management's responsibility to safeguard the assets of the organization. Prudent business practice indicates that the Commission should protect its cash deposits by providing for adequate collateral.

The Commission could look to Minn. Stat. Section 118.01 pertaining to the deposit of public funds by municipalities for determining collateral requirements. Similarly, Minn. Stat. Section 9.031 addresses deposits of state funds.

Recommendation

- The Minnesota State Armory Building Commission should require collateral for account balances exceeding \$100,000.*

- 2. The Minnesota State Armory Building Commission is not monitoring for compliance with the federal arbitrage restriction and rebate requirements.**

The Commission does not have a process in place to monitor compliance with federal arbitrage regulations. As the issuing authority of tax-exempt bonds, the Commission is required by federal regulations to monitor each of its bond issues for compliance with federal arbitrage and rebate requirements.

Arbitrage refers to profits earned from investing low-yielding tax-exempt bond proceeds at a higher rate of return than paid on the bonds. When arbitrage occurs, the bond issuer becomes liable for a rebate to the federal government. If an issuer does not monitor for arbitrage and doesn't make the appropriate rebate payments, when necessary, they could become liable for additional penalties or lose the tax-exempt status of the bonds.

Department of Military Affairs

There are two major arbitrage compliance areas: arbitrage restriction requirements and arbitrage rebate requirements. Arbitrage restriction requirements were introduced in 1969 and describe circumstances in which investments in materially higher yielding securities is allowed without compromising the tax-exempt status of the bond issue. These circumstances include situations when issuers reasonably expect to spend the bond proceeds within a three year time period. Arbitrage rebate requirements were introduced with the Tax Reform Act of 1986. The rebate requirements identify what must be done with profits earned from those securities under the arbitrage restriction requirements.

U.S. Treasury Regulations Section 1.148-8(d)(1) defines the funds subject to arbitrage restrictions and rebate requirements. This definition uses the term "gross proceeds" which includes "any proceeds of the issue and any replacement proceeds of the issue." Therefore, funds subject to arbitrage rebate requirements include the original bond proceeds as well as replacement proceeds held in a sinking fund, reserve or replacement fund.

Arbitrage regulations are meant to address the situation when an issuer of tax-exempt bonds takes advantage of their tax-exempt status and incurs debt for the purpose of earning investment income and not for a designated purpose. There is no evidence that the Commission has issued bonds except to finance the new construction of new National Guard armories around the state. On average, new armory construction is completed within 18 months.

Recommendation

- *The Commission should monitor proceeds from each tax-exempt bond issue for compliance with federal arbitrage restriction and rebate requirements.*

3. The Department is not in compliance with Minn. Stat. Section 16B.17.

The Department of Military Affairs has entered into a professional service contract for an executive director position with a former employee. The former employee, who held the position of comptroller for the department for many years, was required to retire at age 62 according to National Guard regulations. The Adjutant General entered into an annual contract with the former comptroller to serve as his executive director. Under Minn. Stat. Section 190.08, Subd. 1a, "The adjutant general may appoint an executive director of the department of military affairs. The executive director shall serve at the pleasure of the adjutant general."

Minn. Stat. Section 16B.17, Subd 1 (b), provides in part that "professional and technical services are predominantly intellectual in character...do not involve the provision of supplies or materials, and the final result is the completion of a task rather than analysis, evaluation, prediction, planning or recommendation. Under Minn. Stat. Section 16B.17, Subd. 2, the Commissioner of Administration, before approving a proposed state contract for professional and technical services, must determine, among other things that:

...the contract will not establish an employment relationship between the state or the agency and any persons performing under the contract...

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Minn. Stat. 16B.17, Subd. 3, requires a contracting agency to make certain certifications to the Commissioner of Administration before seeking approval of the contract. The Department of Administration did approve of the professional service contract based on those certifications by the Department of Military Affairs.

Since the duties and responsibilities of this individual have not substantially changed as a result of his retirement from the comptroller position to his appointment to executive director, we believe that an employment relationship continues to exist as it did before retirement. The compensation level for the comptroller and executive director positions are similar.

The department believes that using a professional service contract to fulfill the responsibilities required of the executive director position best meet the needs of the department. Also, the department believes that the nature of the relationship is one of contracting agency and consultant, not employer/employee.

Recommendation

- *The department should comply with Minn. Stat. Section 16B.17, Subd. 2.*

4. The department overcompensated three National Guard members under the re-enlistment bonus and tuition reimbursement programs.

During fiscal year 1993, the department overpaid three members of the National Guard by \$605. One member received two cash bonuses within one re-enlistment period. Under the tuition reimbursement program, the department inappropriately reimbursed individuals who had already received a cash re-enlistment bonus.

The department is authorized by Minn. Stat. Section 192.501 to offer a \$250 cash bonus to members of the National Guard for each year they re-enlist, up to seven years. The department is also authorized by Minn. Stat. Section 192.501(1) to offer tuition reimbursement to members of the National Guard enrolled in higher education. Members of the National Guard receiving tuition reimbursement are not eligible for the re-enlistment bonus within the same year.

The amount of overpayment to three National Guard members receiving payments from both programs totaled \$605. Payment transactions, for both programs, are generated from two separate data bases of eligible individuals. The computerized process used to compare individuals in both data bases, is not effective in identifying all potential overpayments.

For one individual receiving two re-enlistment bonuses in one year, the individual's enlistment anniversary date was inadvertently changed in the data base. Individuals become eligible to receive the bonus on their enlistment anniversary date. The computerized data base of eligible individuals does not protect the anniversary date field from change. The amount of overpayment was \$250.

Department of Military Affairs

Recommendations

- *The department should improve controls over re enlistment bonuses and tuition reimbursement payment transactions, to ensure that overpayments do not occur.*
- *The department should seek recovery of the ineligible payments.*

5. The department did not monitor an interagency agreement with the Department of Natural Resources.

Military Affairs' review of payroll records, or other controls to monitor interagency agreements, did not detect an overpayment of payroll expense charged to the department by another state agency. Payroll expense, charged to the department, exceeded the amount of an interagency agreement between Military Affairs and the Department of Natural Resources, by \$1,558.60.

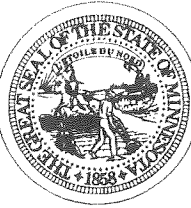
The department entered into an interagency agreement with the Department of Natural Resources, for work to be performed by a DNR employee. The amount of the agreement was not to exceed \$2,640. During the time the agreement was in effect, the DNR charged all of the employee's payroll expense of \$4,198.60 to the department. Payroll procedures require that the department control the hours worked and properly report the data to the home department.

Recommendations

- *The department should improve controls over interagency agreements.*
- *The department should seek reimbursement from the Department of Natural Resource for the amount of overpayment.*

DEPARTMENT OF MILITARY AFFAIRS

MINNESOTA ARMY AND AIR NATIONAL GUARD



OFFICE OF THE ADJUTANT GENERAL

VETERANS SERVICE BUILDING

STATE OF MINNESOTA

20 WEST 12TH STREET

ST. PAUL, MINNESOTA 55155-2098

8 June 1994

Mr. James R. Nobles
Legislative Auditor
Centennial Building
St. Paul, MN 55155

Dear Mr. Nobles:

The following comments are furnished relative to the draft audit report summarizing the results of your audit work for this agency for the fiscal year ending June 30, 1993.

Current Findings, Recommendations and Response

Recommendations:

The Minnesota State Armory Building Commission should require collateral for account balances exceeding \$100,000.

Department Response:

The MSABC has entered into a collateral agreement for its checking account in the amount of \$395,000. The \$2,389,219 transaction was an instantaneous in and out wire transaction.

The Commission should monitor proceeds from each tax-exempt bond issue for compliance with federal arbitrage restriction and rebate requirements.

Department Response:

The MSABC has established an arbitrage monitoring system to ensure compliance with arbitrage regulations. The MSABC continues to work with its bond counsel to ensure that bond proceeds are monitored correctly to qualify for the two year construction exception.

The department should comply with Minn. Stat. Section 16B.17, Subd.2.

Department Response:

The position description of the Executive Director has been revised to be in compliance with MN Statutes Section 16B.17.

The position description has been revised to reflect that the final result will be analysis, evaluation, prediction, planning or recommendation rather than completion of a task. Any relationship implied between the state or agency by any person performing under the contract has been severed. This status will continue during the period covered by this contract.

To the point mentioned in the attached Legislative Audit report regarding duties and responsibilities with regard to the employment relationship continuing, please be advised that under the revised position description any implied or expressed employment relationship is amended to reflect a relationship of the contracting agency and consultant, and not employer/employee.

The department should improve controls over re-enlistment bonuses and tuition reimbursement payment transactions, to ensure that over payments do not occur.

The department should seek recovery of the ineligible payments.

Department Response:

All information pertaining to individuals receiving tuition reimbursement and re-enlistment bonus has been consolidated into one program within a PC ensuring easy cross-reference.

The three (3) individuals who were overpaid due to receiving both tuition reimbursement and the re-enlistment bonus have been informed. Two (2) have opted to repay the overpayment by not receiving tuition reimbursement due them and a refund to the state for the rest. The third individual will have the difference deducted from his next tuition reimbursement. We have currently received partial payments from the two (2) individuals who opted to refund the state.

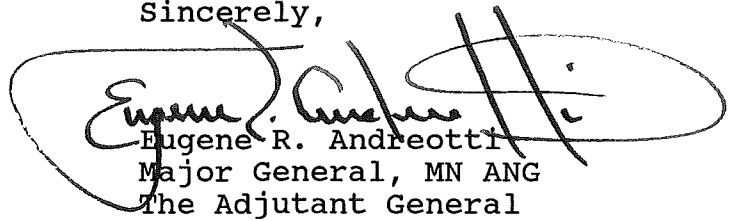
The department should improve controls over interagency agreements.

The department should seek reimbursement from the Department of Natural Resource for the amount of over payment.

A procedure has been put in place where, when an employee of DNR performs work for this agency, the supervisor of the project at Camp Ripley will sign off on the individuals time and attendance report, or attach a statement of work for the period indicated.

Reimbursement has been received.

Sincerely,



Eugene R. Andreotti
Major General, MN ANG
The Adjutant General