MINNESOTA SUPERCOMPUTER CENTER, INC.

FINANCIAL AUDIT

FOR THE TWO YEARS ENDED JUNE 30, 1993

JUNE 1994

Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

94-32

Centennial Office Building, Saint Paul, MN 55155 ● 612/296-4708

SUMMARY

State of Minnesota
Office of the Legislative Auditor
Centennial Office Building • St. Paul, MN 55155
612/296-4708

MINNESOTA SUPERCOMPUTER CENTER, INC.

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Public Release Date: June 22, 1994 No. 94-32

Background

The University of Minnesota created Minnesota Supercomputer Center, Inc. (MSCI) in 1982. The University and the University of Minnesota Foundation own 10 percent and 90 percent of MSCI's common stock, respectively. The University established MSCI to obtain affordable access to state-of the art supercomputing services.

Audit Areas

Computer Use Revenue

Minnesota Supercomputer Center, Inc. has a complex billing and collection process that helps maximize commercial revenues. MSCI has adequate controls over its billing and receipt processing functions. However, management could improve its process for accumulating resource data with additional accounting controls.

Employee Compensation

MSCI compensation levels are reasonable in comparison with industry averages which are based primarily on the private sector. MSCI does not provide employees with significant types of non-cash compensation or "perks." A portion of most employees' compensation includes incentive payments, which are dependent on the corporation's financial status and individual performance. We think controls over incentive payments should be improved by a formal board policy limiting the amount of such payments and annual reporting of the amounts paid.

Other Areas

In reviewing three selected other areas, we found that MSCI was making limited purchases from the University, and was appropriately paying sales tax on its purchases. In addition, MSCI made board member director fee payments only to its external board members. Finally, MSCI had established appropriate travel reimbursement practices.

Contact the Financial Audit Division for additional information.
296-1730

STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
CENTENNIAL BUILDING, ST. PAUL, MN 55155 • 612/296-4708
JAMES R. NOBLES, LEGISLATIVE AUDITOR

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Members of the Board of Directors
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Mr. John M. Sell, President and CEO
Minnesota Supercomputer Center, Inc.

Audit Scope

We have completed a financial related audit of selected activities of the Minnesota Supercomputer Center, Inc. (MSCI) for the two years ended June 30, 1993. We emphasize that we did not conduct a complete audit of all financial activities of the Minnesota Supercomputer Center, Inc. We limited our audit to the financial operations outlined below and discussed in the Introduction.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we consider an organization's internal control structure in order to plan our audit of the selected activities, and that we perform tests of the organization's compliance with certain material provisions of laws, regulations, contracts and grants. However, it was not our objective to provide an opinion on MSCI's internal control structure or on its overall compliance with finance-related legal provisions.

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

- Revenue
- Employee Compensation

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

In addition, we examined certain transactions and practices that we considered to be generally more susceptible to misuse, including purchases from the University and sales tax payments, board member director fees, and travel reimbursements.

Audit Techniques

In our audit of MSCI, we interviewed corporation staff to gain an understanding of its financial policies and practices. We also reviewed supporting documentation for selected financial transactions. Field work was conducted from February to April 1994.

MSCI staff provided us with full access to the corporation's financial records during this audit. They gave us computer files of MSCI's financial transactions that balanced to the corporation's audited financial statements. We were able to use these files to search for inappropriate transactions and payments and identify revenue sources and operating transactions. MSCI provided the requested information to us in a timely manner.

Management Responsibilities

MSCI's management is responsible for establishing and maintaining the internal control structure. This responsibility includes compliance with applicable laws, regulations, contracts, and grants. In fulfilling this responsibility, management uses estimates and judgments 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 in the corporation's general ledger system.

Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the internal control 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.

Conclusions

Minnesota Supercomputer Center, Inc. has a complex billing and collection process that helps maximize commercial revenues. MSCI has adequate controls over its billing and receipt processing functions. However, management could improve its process for accumulating resource use data with additional accounting controls. We discuss our conclusions on computer use revenue in Chapter 2.

MSCI compensates its employees slightly above industry average salaries. We think control over the incentive payment portion of employee compensation should be improved. We discuss our conclusions on employee compensation in Chapter 3.

In Chapter 4, we discuss our conclusions from the review of three other expense areas, purchases from the University, directors fees for board members, and travel reimbursements. We found that MSCI made limited purchases from the University and appropriately paid sales tax on its purchases. Also, MSCI made payments only to its external directors. Finally, MSCI had established appropriate travel reimbursement practices.

This report is intended for the information of the Legislative Audit Commission and the management of the Minnesota Supercomputer Center, Inc. This restriction is not intended to limit the distribution of this report, which was released as a public document on June 22, 1994.

We thank the MSCI staff for their cooperation during this audit.

James R. Nobles
Legislative Auditor

John Asmussen, CPA
Deputy Legislative Auditor

End of Fieldwork: April 8, 1994

Report Signed On: June 17, 1994

Minnesota Supercomputer Center, Inc.

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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
Claudia Gudvangen, CPA	Audit Manager
Cecile Ferkul, CPA	Auditor-in-Charge
Chris Buse, CPA	Staff Auditor
Fubara Dapper	Staff Auditor
Kari Irber, CPA	Staff Auditor

Chapter 1. Introduction

In 1982 the University of Minnesota created Minnesota Supercomputer Center, Inc., (MSCI) as a private, for-profit corporation. The University and the University of Minnesota Foundation own 10 percent and 90 percent of MSCI's common stock, respectively. In addition, the University owns all of the 22,500 shares of outstanding preferred stock. The University established MSCI to obtain affordable access to state-of-the-art supercomputing services. MSCI's ability to market to corporate users of supercomputer services provides a broader base to share the cost of upgrading and maintaining computer equipment.

There has been public concern about the relationship between MSCI and the University because of a perceived lack of accountability. The University has used millions of dollars to develop MSCI and to purchase supercomputer services from it . Much of the controversy is due to the level of secrecy that MSCI maintains over all aspects of its operations. Aside from its University contract information, essentially all of the details of MSCI's organizational structure, staffing, customers, revenues, and operating expenses are designated by MSCI as trade secrets.

To answer questions about MSCI's operations, the Legislative Audit Commission directed the Financial Audit Division to conduct a financial audit of MSCI. The commission also directed the Program Evaluation Division to review the corporation's rate structure and to determine whether the University is getting good value in its contractual arrangement with MSCI. The two studies were conducted separately. The Program Evaluation Division also released its report on June 22, 1994.

The primary objective of our financial audit was to determine the appropriateness of MSCI's financial activity. More specifically, we focused our audit work on the following questions:

- Does MSCI have a process to ensure that it maximizes commercial revenue? Commercial revenue enables MSCI to provide the University with low cost supercomputer services. Therefore, lost revenue could result in higher costs to the University.

- Does MSCI provide reasonable levels of compensation for its employees? Payroll and related expenses are significant expenses for MSCI.

Chapters 2 and 3 address these questions.

In addition we examined various transactions and practices that we thought were generally more susceptible to misuse. In Chapter 4 we discuss conclusions from our review of:

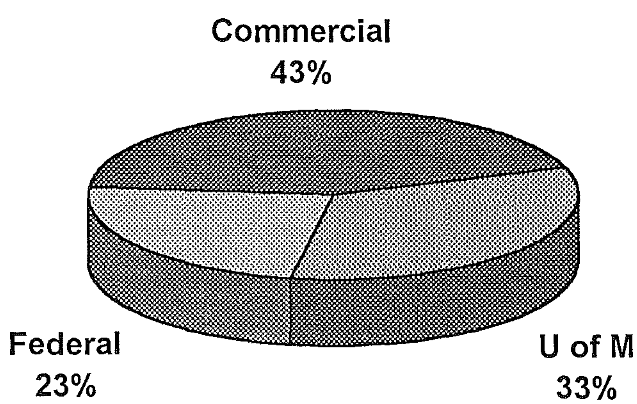
- Purchases from or through the University and sales tax payments;
- Board member director fees; and
- Travel reimbursements.

In determining the scope of our audit, we considered MSCI's other audit coverage. MSCI has had an annual audit of its financial statements by a certified public accounting firm since its incorporation. The objective of MSCI's annual financial audits was to determine if the corporation's financial statements were fairly presented in accordance with generally accepted accounting principles (GAAP). KMPG Peat Marwick issued unqualified audit opinions on MSCI's financial statements for fiscal years 1992 and 1993. We also considered the work done by the Program Evaluation Division in reviewing MSCI's rate structure. We designed our audit approach to supplement rather than duplicate the work done in these other examinations and evaluation.

Financial Analysis

Figure 1.1 identifies MSCI's revenue sources in fiscal years 1992 and 1993. Total operating revenue in fiscal year 1993 was $22,282,943, an increase of four percent from fiscal year 1992 revenue of $21,448,049.

Figure 1.1
Operating Revenue
Fiscal Years 1992 and 1993



Source: MSCI audited financial statements.

An analysis of the revenue categories shows:

- On July 1, 1992, the University entered into a four-year agreement with MSCI. In exchange for $8 million, paid at the beginning of each fiscal year, the University receives a guaranteed amount of supercomputer resources. The University also receives a gift of MSCI supercomputer resources not used by other customers. Operating revenue from this and other smaller University contracts totaled $8,024,645 in fiscal year 1993, compared with fiscal year 1992 operating revenue of $6,462,444. However, MSCI incurred additional expenses in fiscal year 1993 for items previously borne by the

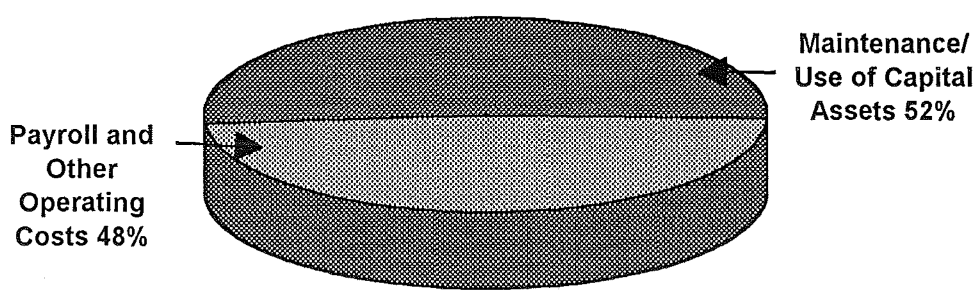
University. In its June 1993 report, the Program Evaluation Division identified net occupancy costs of $1.2 million incurred by the University on behalf of MSCI for fiscal year 1992. Although MSCI assumed financial responsibility for these occupancy costs in fiscal year 1993, it did not expend as much as the University had.

- MSCI received federal revenue for several projects funded either directly by the federal government or indirectly through the University. These federal projects generated $5,458,063 in fiscal year 1993, a 14 percent increase over fiscal year 1992 revenue of $4,799,903.

- Commercial revenue declined from $10,185,702 in fiscal year 1992 to $8,800,235 in fiscal year 1993. We discuss this further in Chapter 2.

Figure 1.2 shows MSCI's major expense categories. Fiscal year 1993 operating expenses totaled $19,647,127, down 11 percent from the fiscal year 1992 total of $22,016,745.

Figure 1.2
Operating Expenses
Fiscal Years 1992 and 1993



Source: MSCI audited financial statements.

At June 30, 1993, MSCI's stockholders' equity, which includes preferred and common stock, additional paid in capital and retained earnings totaled $10,405,456, a 20 percent increase from the June 30, 1992 total of $8,639,028.

MSCI considers virtually all of its financial data and related documents, other than its University contracts, to be "trade secrets" under the Minnesota Government Data Practices Act. As a result, we cannot make this information public. This limits our ability to show how we arrived at our findings and conclusions.

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Chapter 2. Computer Use Revenue

Chapter Conclusions

Minnesota Supercomputer Center, Inc. has a complex billing and collection process that helps maximize commercial revenues. MSCI has adequate controls over its billing and receipt processing functions. However, management could improve its process for accumulating resource use data with additional accounting controls.

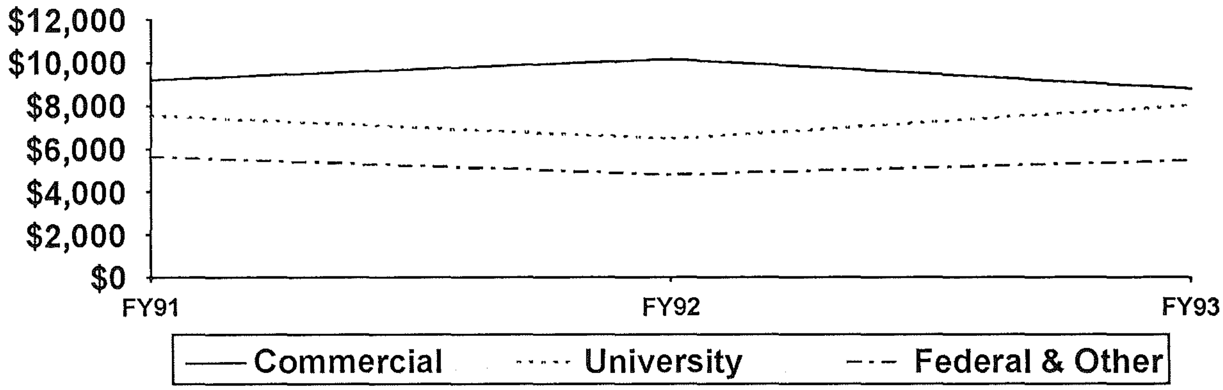
The overall objective of this portion of our audit was to determine if MSCI has a billing and collection process that results in the maximization of revenues. To fulfill this objective, we identified the process used to accumulate information on computer resource use. We then reviewed procedures for billing resource use to customers. We concluded with a review of accounts receivable, revenue recognition, and receipt processing procedures.

Revenue Analysis By Type Of Customer

MSCI provides supercomputing services to commercial customers, the University of Minnesota, and federal agencies. Commercial customers are the largest source of revenue for the corporation. However, the gap between commercial customer and University revenues is narrowing. Fiscal year 1993 commercial customer and University of Minnesota revenues were $8,800,235 and $8,024,645, respectively.

The MSCI's total operating revenues have remained fairly stable for the last three fiscal years. As figure 2.1 depicts, commercial customer revenue suffered a 13.6 percent decline in fiscal year 1993. However, an increase in the fixed commitment paid by the University partially offset this decline. The University's annual services commitment increased from $6,454,000 to $8,000,000 on July 1, 1992. At the same time, MSCI assumed responsibility for some lease expenses previously borne by the University.

Figure 2.1
Total Revenue By Customer Type (in Thousands)



Source: MSCI audited financial statements.

Accumulating and Valuing Computer Use Data

MSCI has a series of very sophisticated computer applications that accumulate, summarize, and value resource use data. The main resources that MSCI bills customers for are CPU time, memory, and data transfer. The operating system on each supercomputer accumulates resource use data for every command, or "process," initiated by a user. When processing finishes, the operating system writes a detailed resource use record for each command. It also writes detailed resource use records for commands interrupted in process, or "checkpointed". These resource use records capture the raw data that the corporation uses to bill customers. MSCI estimates that each supercomputer writes approximately 60,000 detailed resource use records every day.

Each day, a computer application developed by MSCI reads the detailed records and computes the number of system resource units (SRUs) for each command. SRUs are the standard billing unit for computer resource use. This application also summarizes the detailed records and writes daily resource records for each user. Each customer contract specifies a SRU formula as well as a rate per SRU. However, all customers do not have the same SRU formula, nor do they pay the same rates. SRU formulas take into consideration a number of factors, the most significant of which include CPU seconds used, memory used, and the amount of input/output data transferred (I/O). The daily resource use records compiled by this application include the number of SRUs.

A second application summarizes these daily records for each user and writes monthly resource use records. These monthly records are then read by a third application, which multiplies the resource use quantities by the applicable rate to determine the amount billed to the user. MSCI accountants use this application to generate a monthly billing file. Customers can also use this application to monitor monthly resource use.

Controls Over the Resource Accumulation Process

Most controls over the resource accumulation process focus on the completeness and accuracy of CPU time. MSCI runs a daily 10 second test job on each machine to verify that the resource accounting applications are accurately accumulating and summarizing the CPU seconds used. The corporation also generates daily reports to account for all available CPU seconds on each supercomputer. We think that this focus is appropriate since CPU time is the most significant factor in the SRU formula. However, memory use can be a significant factor for jobs that use a large percentage of a supercomputer's available memory. I/O (the amount of input/output data transferred) can also be a significant factor in jobs that move large amounts of data. Therefore, we think that the corporation could strengthen its internal control structure by expanding its computerized edits to include these resources as well.

1. MSCI could improve controls over the resource accumulation process with additional computerized edits.

MSCI could add further controls to verify the ongoing accuracy of memory and I/O data accumulated by its resource accounting applications. Also, the corporation has limited controls to determine if these applications are summarizing SRUs properly. Without these controls, management may have difficulty detecting unintentional or unauthorized changes to the resource accounting applications. Currently, MSCI tests to be sure memory and I/O usage totals are being collected daily. Automated limits are in place to detect significant deviations from expected levels. System staff and senior management receive daily on-line reports of usage which they screen for unusual patterns and occurrences.

The underlying concept behind MSCI's billing process is that customers should pay for the resources they use. To achieve this goal, MSCI's systems software staff must make extensive changes to the standard supercomputer operating systems. These changes provide enhanced accounting capabilities as they allow the corporation to capture detailed resource use data that otherwise would not be available. However, they also increase the need for controls to confirm the ongoing accuracy of the resource accumulation process. This is particularly true at MSCI since the corporation must make complex modifications to all new operating system versions released by the software vendor.

Resource accounting merits a high level of control because it is one of MSCI's most critical business functions. Therefore, the MSCI should consider broadening the scope of its automated accumulation controls to encompass more than just CPU time. One possible solution may be to expand the daily 10 second test job to include accumulation controls over memory usage, I/O, and SRUs. Another improvement may be to compute SRU control totals and monitor these totals throughout the resource accounting process.

Recommendation

- *MSCI should consider developing resource accounting computerized edits to control memory usage, I/O, and SRUs.*

Billing Customers and Collecting Receipts.

MSCI's billing process relies on the accuracy and completeness of the accumulated resource use data. Accounting staff produce a monthly invoicing file from this accumulated data. They also adjust some customer's charges to reflect special contractual terms. These adjustments can be very complex. Therefore, the Controller reviews all invoices before staff mail them to customers. The Director of Customer Support also reviews invoices for some of the largest customers. Accounting staff then enter the invoices in the corporation's general ledger system as accounts receivable. When payments arrive, they post the amounts received against these accounts receivable balances.

Based on our review, we conclude that MSCI has adequate controls over its billing and receipt processing functions. In addition, we think MSCI has a highly qualified accounting staff, and their work is closely scrutinized by management. In addition, the corporation has properly separated incompatible accounting duties to minimize the risk or errors or irregularities.

Chapter 3. Employee Compensation

Chapter Conclusions

MSCI compensation levels are reasonable in comparison with industry averages which are based primarily on the private sector. MSCI does not provide employees with significant types of non-cash compensation or "perks." A portion of most employees' compensation includes incentive payments, which are dependent on the corporation's financial status and individual performance. We think controls over incentive payments should be improved by a formal board policy limiting the amount of such payments and annual reporting of the amounts paid.

We examined the area of employee compensation for two reasons.

- Our first objective was to determine whether overall compensation was reasonable. Payroll and related costs are significant expenses for MSCI. They are the corporation's second largest expense category.

- In addition, we thought there was a risk that MSCI's management could provide employee "perks" and non-cash compensation that would not be acceptable if subjected to public scrutiny.

Description of MSCI Compensation Plan

MSCI compensates its employees at levels slightly higher than the industry average. MSCI asserts that its employees are highly trained, experienced and sought after. Consequently, it pays staff at a level necessary to attract, motivate and retain them. Employee compensation includes an incentive payment based on personal and corporate performance. MSCI management thinks the incentive payment will keep staff competitive and productive. Through the incentive payment, employees share the "risk" of financial performance. For fiscal years 1992 and 1993, most employees were eligible for an incentive payment. The incentive payments are dependent on the financial success of the corporation and satisfactory individual performance.

MSCI offers its employees a fairly standard fringe benefit package compared to public entities. It did not provide many extra "perks" to its employees. Employees do not have corporate cars, cellular phones, club memberships, "free time" on the supercomputers, or any other type of non-cash compensation. The only extras we found were expenses for occasional office parties. MSCI spent $6,000 in fiscal year 1992 and $8,500 in fiscal year 1993 for holiday parties. It also spent about $1,900 in fiscal year 1992 for an office picnic.

Minnesota Supercomputer Center, Inc.

During fiscal year 1993 MSCI employed staff in 86 positions. Employees receive biweekly paychecks for their base pay, and an annual payment for the incentive portion of their compensation. In addition to this direct compensation, MSCI provides employees with two to three weeks paid vacation and 40 hours of sick leave each year. Employees also receive medical insurance and optional life and long term disability insurance and MSCI contributes to a retirement plan for eligible participants. Employees are eligible for an additional four weeks paid sabbatical leave in the year after each five year period of employment. Essentially, the sabbatical leave is simply paid vacation.

MSCI management states that the total compensation package, combining the elements stated above, provides compensation to its staff at a rate above the industry average. MSCI designed its compensation package to be competitive with the larger corporations from which it draws talented employees, while remaining within available resources. Our testing, described in a subsequent section, showed that MSCI direct compensation (which includes base pay and incentive pay) for a sample of employees exceeded industry average salaries by an average of five percent.

Characterization of Incentive Pay

The concept of performance based or incentive pay raised two questions:

- Are there sufficient limits and adequate controls over the incentive payments?

- Does the incentive payment result in excessive employee compensation?

The principle behind incentive pay is that MSCI puts a portion of the employee's pay "at risk". Thus, the employee has a personal stake in the financial outcome of the corporation. The amount of "at risk" compensation is a percentage of the employee's base pay and varies with the degree to which decisions or actions by the employees affect the overall performance of the corporation. MSCI bases part of the incentive payment on company performance and part on the individual's specific job performance. In fiscal years 1992 and 1993, incentive payments averaged about 17 percent of base pay.

Incentive payments were first made in August 1989, for financial performance in fiscal year 1989. The Board of Directors authorizes the incentive payments after analysis of the ability of the corporation to meet different levels of commitments. At the end of each year, the board specifically sets the incentive amount for the president and executive vice-president, and then sets the percentage limits for the other levels of management and staff. Supervisors determine the specific percentages individual staff receive. Full-time employees, other than sales staff, receive a portion of the authorized amount, and the remainder is based on individual performance. Since the incentive payments are dependent upon the financial success of the corporation, the incentive payment concept gives the corporation an easy way to cut back on a significant expense if necessary. MSCI could cut its payroll costs and its total expenses by eliminating the incentive payments. For fiscal years 1989 to 1993 MSCI did not have to eliminate incentive payments as a cost cutting measure.

2. The MSCI board does not have a formal policy defining and limiting its incentive pay program.

The board enjoys great discretion in establishing employee compensation levels and determining incentive pay. We are concerned that the board could significantly increase incentive payments without adequate consideration of stockholder interests.

Since the incentive payment plan is implemented at the discretion of the board on an annual basis, there is no assurance that future payments will be reasonable or appropriate. The board does not establish a budget for incentive payments at the beginning of the year. Management accrues an estimated incentive payment amount in the accounting records based on the prior year payments. Actual payments for fiscal years 1992 and 1993 were less than the amounts accrued.

The board began the incentive program in 1989, somewhat on an ad hoc basis. We think it is now time to formalize the practices. MSCI is not subject to the compensation disclosure requirements for publicly traded corporations. As a for-profit company, MSCI's board meetings are not open. Thus, board members need to be especially cautious that the incentive payments do not exceed prudent levels.

Recommendations

- *The MSCI board should adopt a formal policy defining eligibility for incentive pay and limiting the amount annually available to employees.*

- *MSCI should annually report employee compensation and the amount of incentive payments to its share holders (the University Board of Regents and the University Foundation Board of Directors). In addition, MSCI should provide information about how the compensation levels compare with industry averages.*

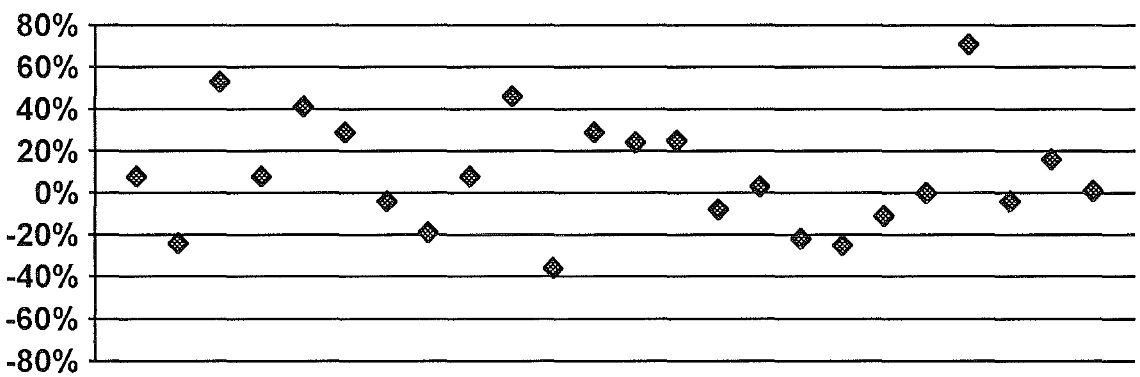
Testing Results

To test whether compensation levels were excessive, we compared actual MSCI compensation to average industry compensation. We utilized an October 1991 study done by DCA, Inc., for MSCI's board. DCA, Inc., used a variety of market surveys and a special survey to identify position compensation data comparable to positions at MSCI. The special survey included hardware vendors, software vendors, users and software providers.

For purposes of our testing we adjusted the DCA survey information by 4.5 percent for general salary adjustments since fiscal year 1992. Because MSCI is not subject to the compensation limitations applicable in the public sector, we tested the highest salaried employees. We also tested a sample of other employees. The total tested was 42 percent of fiscal year 1993 compensation, representing 24 percent of the employees. We compared the total of base pay and incentive pay to the compensation amounts in the survey.

We found that on average, the total compensation for the sample tested was five percent above the average compensation for similar positions in the industry. As individuals, there were some salaries significantly above the averages, and some salaries significantly below the averages, as can be seen in Figure 3.1. The individual variances are not pervasive or significant enough to have an effect on the overall payroll cost. MSCI explains these instances of higher than average compensation as being attributable to the value of the employee's work contribution, the degree of dedication to the corporation, leadership ability, creativity, and unique talents. The DCA, Inc., report states that in this industry there is "considerable 'personalizing' of pay on the basis of incumbent skills, supply and demand, fields of expertise, etc."

Figure 3.1
Percentage Variance of Employee Compensation from Average Industry Compensation (0%) for a Sample of Employees
Fiscal Year 1993



Source: OLA analysis of MSCI accounting records and October 1991 DCA, Inc. study.

Chapter 4. Other Issues

Chapter Conclusion

We examined three other areas of MSCI operating expenses. We found that MSCI was making limited purchases from the University and that it was appropriately paying sales tax on its purchases. When reviewing board member director fees, we found that MSCI made payments only to its external board members. Finally, we found that MSCI had established appropriate travel reimbursement practices.

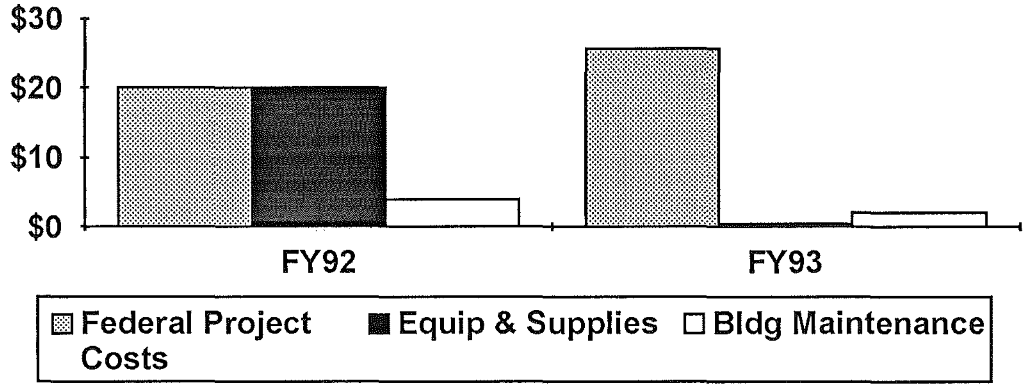
In its October 1992 report, the Program Evaluation Division raised a question about possible inappropriate MSCI purchases through the University. However, it could not answer the question at the time without access to MSCI's records. We examined that issue and two other potentially sensitive expense areas: payments to MSCI board members and travel reimbursements.

Purchases from or through the University

The October 1992 Program Evaluation Division report verified that MSCI made $13,000 in computer equipment purchases from the University bookstore in 1992. They were told that such purchases may have totaled as much as $150,000. The report also discussed purchases from the University's Central Stores and through the purchasing section. The report raised concerns that MSCI was benefiting from vendor discounts intended for University faculty, staff, employees and departments. These concerns were determined to be unfounded.

We examined the payments MSCI made to the University during fiscal years 1992 and 1993 that were not related to building rent. Figure 4.1 shows the breakdown of these payments. There was a decrease in purchases of equipment and supplies, from approximately $22,000 in fiscal year 1992 to under $500 in fiscal year 1993. Federal project costs include purchases made for the Army High Performance Computing Research Center, which receives funding from a federal grant to the University. MSCI performs certain infrastructure support and advanced system acquisition for the project.

Figure 4.1
Nonrent Payments to the University
(in Thousands)



Source: MSCI accounting records.

Another concern related to purchases through the University was whether MSCI was benefiting from the University's tax exempt status. The Program Evaluation Division could not confirm whether MSCI paid the appropriate sales tax if vendors confused the corporation with a University department. We reviewed the process that MSCI follows to monitor sales tax payments. We found that some vendors did not appropriately charge MSCI for sales tax. In those instances, however, MSCI recorded the tax owed and paid it directly to the Minnesota Department of Revenue on a monthly basis.

Payments to Board Members

In fiscal years 1992 and 1993, MSCI paid board member director fees totaling $51,800 and $46,100, respectively, to its external directors. We were concerned that University administrative officers and MSCI's president received compensation for their board duties. We did not believe that it would be appropriate for these individuals to receive additional compensation from an organization in which the University has an ownership interest. We found that MSCI made no payments to these board members. MSCI's board had a policy that the company did not compensate these "inside directors."

In fiscal year 1994 the board developed a new policy because University administrative officers were replaced by faculty members on the board. In appreciation of these board members' services, MSCI makes charitable contributions to the faculty members' departments. Through March 25, 1994, MSCI paid a total of $17,389 to the Mechanical Engineering Department, Computer Science Department, the Humphrey Institute of Public Affairs and the University of Minnesota Foundation.

Travel Reimbursements

Travel reimbursements are an area that can potentially be subject to abuse. We reviewed the travel reimbursements to MSCI staff during our audit period. In fiscal year 1993 only 11 of 81 employees received travel reimbursements exceeding $2,000. Most of these employees were in MSCI's marketing division. We examined all reimbursements to the head of the marketing unit in fiscal year 1993. We found that MSCI requires detailed support for all types of expenses. The employee documented the business purpose of the trips and identified any personal expenses such as telephone calls, movies or laundry. MSCI did not reimburse for these personal items. MSCI's management thoroughly reviewed this employee's reimbursement requests prior to payment.

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Minnesota Supercomputer Center, Inc.

June 17, 1994

Mr. James R. Nobles
Legislative Auditor
State of Minnesota
Centennial Building
St. Paul, Minnesota 55155

Dear Jim:

This letter serves as the written response of Minnesota Supercomputer Center, Inc. ("MSCI") to the final report of the Financial Audit Division of your office regarding MSCI which has been delivered to MSCI (the "Report").

The Report includes a number of findings which we believe reflect favorably on the practices of accountability which MSCI has followed in conducting its business. Those practices are appropriate to MSCI as a business corporation. While they may vary from those which a public body would follow, they nevertheless ensure that MSCI is able to responsibly conduct and report on its activities. In fact, in areas such as accounting for use of its systems MSCI has pioneered new levels of sophistication in developing a system resource accounting process which is, to our knowledge, unsurpassed by any other center in the world. Moreover, as the Report reflects, the thorough financial accounting systems implemented by MSCI are maintained by a highly qualified professional staff whose work is closely reviewed by company management.

The Report sets forth two recommendations which we wish to address. The first relates to the controls within the MSCI system resource accounting process which measure the accumulation of various components of the computing services of MSCI. While existing controls are in place which would indicate significant accumulation variances, if any were to occur, these additional measures are being reviewed by MSCI systems personnel for feasibility. A business decision weighing the benefit of the control against cost of development and added complexity will be made by MSCI. We appreciate the diligent effort made by the audit staff to understand this complex accounting process and the constructive nature of this recommendation.

The second recommendation is related to the authorization of incentive compensation awards by the MSCI Board of Directors. We believe that the decision making and documentation process regarding incentive compensation which has been followed by the Board in this context is in accord with proper corporate procedure. Proposals for and reporting of incentive compensation awards are reviewed by the Compensation and Audit Committees of the Board. The Board will review the current procedure for reporting through these committees. The shareholder disclosure recommended in the Report is currently made through the non-public distribution and availability of the company's audited financial statements to the Board of Regents. Those financial statements set out the total incentive compensation award for the current year with comparison to the past year.

We appreciate the sensitivity which you and your office have demonstrated toward the need to preserve the non-public nature of the business information of MSCI which was reviewed in this process. That information will continue to play an important part in MSCI's prospects for continued success.

Thank you for the opportunity to have this response included in the Report.

Sincerely

Stephen R. Pflaum
Chair of the Board, MSCI

cc: Board of Directors, MSCI