

**IRON RANGE RESOURCES AND REHABILITATION
BOARD**

FINANCIAL AUDIT

FOR THE THREE YEARS ENDED JUNE 30, 1993

AUGUST 1994

Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

94-38

SUMMARY

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

IRON RANGE RESOURCES AND REHABILITATION BOARD

FINANCIAL AUDIT FOR THE THREE YEARS ENDED JUNE 30, 1993

Public Release Date: August 12, 1994

No. 94-38

OBJECTIVES:

- ASSESS INTERNAL CONTROL STRUCTURE: Taconite tax receipts, mining company reimbursements, investment income, grant disbursements, loan issuances and repayments, and employee payroll.
- TEST COMPLIANCE WITH CERTAIN FINANCE-RELATED LEGAL PROVISIONS.

CONCLUSIONS:

We found eight areas where the internal control structure needed improvement:

- The IRRRB has not expended \$890,000 from a 1987 General Fund appropriation.
- The IRRRB departed from the grant guidelines without adequate justification.
- The IRRRB has not sufficiently controlled grants made from the Research and Planning Division.
- The IRRRB departed from its loan guidelines without establishing adequate justification.
- The IRRRB did not always adequately monitor delinquent bank participation loans.
- The IRRRB did not obtain board approval before allowing a foreclosed loan to be taken over by a third party.
- The IRRRB did not properly monitor certain aspects of a management service agreement.
- The IRRRB improperly reimbursed a contractor for certain expenses.

We found one departure from finance-related legal provisions:

- The IRRRB funded a project outside the taconite tax relief area.

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

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Legislative Audit Commission

Members of the Legislative Audit Commission

Senator Doug Johnson, Chair
Iron Range Resources and Rehabilitation Board

Members of the Iron Range Resources and Rehabilitation Board

Mr. James Gustafson, Commissioner
Iron Range Resource and Rehabilitation Board

Audit Scope

We have completed a financial related audit of the Iron Range Resource and Rehabilitation Board for the period July 1, 1990 through June 30, 1993 as outlined below, and as further discussed in the Introduction. We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we consider the internal control structure in order to plan our audit, and that we perform tests of the department's compliance with certain material provisions of laws, regulations, contracts and grants. However, our objective was not to provide an opinion on the internal control structure or on overall compliance with finance-related legal provisions.

Internal Control Structure

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

- Taconite tax receipts
- Mining company reimbursements
- Investment income
- Grant disbursements
- Loan issuance and repayments
- Payroll

For 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 assessed control risk.

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Management Responsibilities

Management of the Iron Range Resource and Rehabilitation Board 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, 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 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

Our audit disclosed the conditions discussed in findings 1 to 3 and 5 to 9 involving the internal control structure of the Iron Range Resource and Rehabilitation Board. We consider these conditions to be reportable conditions under 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.

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. Our consideration of the internal control structure would

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not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

During a portion of our audit period, the Iron Range Resources and Rehabilitation Board (IRRRB) did not comply with Minn. Stat. Section 16B.55, subd. 2, which generally disallows the use of a state vehicle for transportation to and from a state employee's residence. From about August 1992 until March 1993, the IRRRB former deputy commissioner routinely used a state car to commute between his home in Ely and the IRRRB offices in Eveleth. When brought to the IRRRB's attention, the deputy commissioner discontinued using the state car for commuting purposes.

The results of our tests of compliance indicate that, except for the issue discussed in the preceding paragraph, and except for this issue discussed in finding 4, with respect to the items tested, the Iron Range Resource and Rehabilitation Board complied, in all material respects, with the provisions referred to in the audit scope paragraphs. With respect to the items not tested, nothing else came to our attention that caused us to believe that the Iron Range Resources and Rehabilitation Board had not complied, in all material respects, with those provisions.

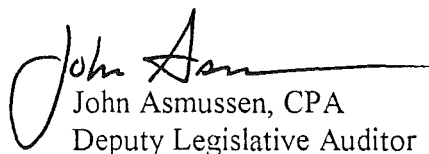
We also noted other matters involving the internal control structure and its operation and/or compliance with laws and regulations that we reported to the management of the Iron Range Resources and Rehabilitation Board at the exit conference held on July 13, 1994.

This report is intended for the information of the Legislative Audit Commission and management of the Iron Range Resource and Rehabilitation Board. This restriction is not intended to limit the distribution of this report, which was released as a public document on August 12, 1994.

We thank the Iron Range Resource and Rehabilitation Board staff for their cooperation during this audit.



James R. Nobles
Legislative Auditor



John Asmussen, CPA
Deputy Legislative Auditor

End of Fieldwork: May 17, 1994

Report Signed On: August 2, 1994

Iron Range Resources and Rehabilitation Board

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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
Jeanine Leifeld, CPA	Audit Manager
Mary Jacobson, CPA	Auditor-in-Charge
Marla Conroy, CPA	Auditor
Kari Irber, CPA	Auditor

Exit Conference

We discussed the issues in this report with the following staff of the Iron Range Resources and Rehabilitation Board on July 13, 1994:

Jim Gustafson	Commissioner
Bob Benner	Assistant Commissioner
Brian Hiti	Senior Planner

Iron Range Resources and Rehabilitation Board

Chapter 1. Introduction

The Legislature created the Iron Range Resources and Rehabilitation Board pursuant to Minn. Laws 1941, Chapter 544, Sec. 4. According to Minn. Stat. Section 298.22, the IRRRB is to develop the remaining resources of the taconite tax relief area of Northeastern Minnesota once the commissioner determines "that distress and unemployment exists or may exist in the future in any county by reason of the removal of natural resources or a possibly limited use in the future and the decrease in employment resulting therefrom . . ." Minn. Stat. Section 273.134 describes the tax relief area as an area which encompasses Minnesota's three iron ranges: the Cuyuna, Mesabi and Vermilion, and covers all or portions of Cook, Lake, St. Louis (excluding Duluth), Itasca, Aitkin and Crow Wing counties.

Pursuant to Minn. Stat. 298.22, Subd. 1, the governor appoints the IRRRB commissioner. Table 1-1 identifies the IRRRB commissioners during the audit period.

Table 1-1
IRRRB Commissioners
1990 to 1993

Name	Dates Served
Jack DeLuca	February 28, 1987-January 7, 1991
Greg Love (Acting)	January 8, 1991-January 31, 1991
Wayne Dalke	February 1, 1991-May 29, 1992
Jim Gustafson	June 3, 1992-present

Source: IRRRB internal documents.

In accordance with Minn. Stat. Section 298.22, the Iron Range Resources and Rehabilitation Board consists of 11 members; five state senators, five state representatives, and the Commissioner of the Department of Natural Resources. The senators and representatives serve for a two year period with a majority from districts in which over 50 percent of the residents reside within the taconite tax relief area.

By statute, the IRRRB operates five accounts. Table 1-2 identifies the specific statutory references pertaining to these five accounts. As explained in Chapter 2, the IRRRB receives most of its funding from a taconite production tax paid by area mining companies in lieu of local property taxes. The IRRRB funds its programs mainly through three accounts; the IRRR Board Account (the basic operating account), the Taconite Environmental Protection Fund, and the Northeast Minnesota Economic Protection Fund. The IRRRB's two remaining accounts receive amounts by statute for the benefit of specific groups. The Taconite Economic Development Fund receives taconite receipts to provide reimbursements to mining company for acquisitions and technology improvements. The Supplemental Tax Environmental Development Account receives

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revenue from occupation taxes rather than taconite production taxes. This money is dedicated for use in Koochiching and Carlton Counties.

Table 1-2
Accounts and Legal References

<u>Account Name</u>	<u>Statutory References</u>
IRRR Board Account	Minn. Stat. 298.22
Supplemental Tax Environmental Development Fund	Minn. Stat. 298.17
Taconite Environmental Protection Fund	Minn. Stat. 298.223
Taconite Economic Development Fund	Minn. Stat. 298.227
Northeast Minnesota Economic Protection Trust Fund	Minn. Stat. 298.292, Minn. Stat. 298.296, and Minn. Stat. 298.2213

Source: IRRRB internal records and statewide accounting system.

The legislature established the Northeast Minnesota Economic Protection Fund as a trust fund. As of February 28, 1994, the fund had a corpus balance of \$57.6 million. Until January 1, 2002, the statutes allow the IRRRB to spend only the interest earned on the corpus. The IRRRB currently can spend interest earnings, as well as any principal and interest received in repayment of loans from the trust fund. During the audit period, the IRRRB earned on average about \$6 million per year in interest on the corpus of the Northeast Minnesota Economic Protection Fund.

To carry out its mission, the IRRRB has established eleven general program divisions. Table 1-3 identifies these divisions.

Table 1-3
Program Divisions

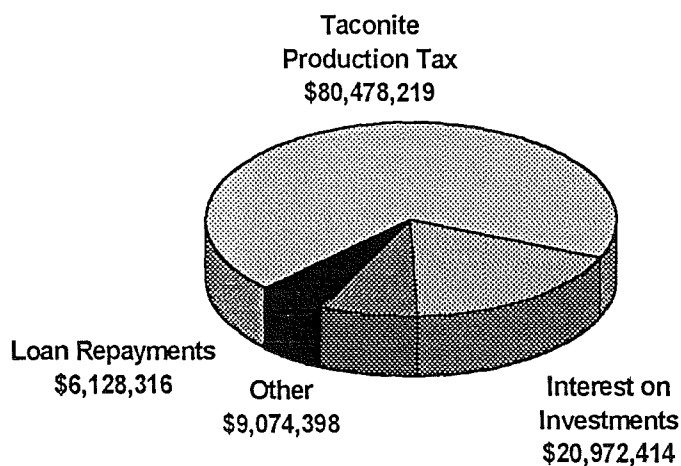
- Building Demolition
- Community Development
- Economic Development
- General Support
- Giants Ridge
- Iron Range Research & Interpretative Center
- Iron World USA
- Mineland Reclamation
- Research and Planning
- Tourism
- Trails

Source: Iron Range Resource and Rehabilitation Internal Information.

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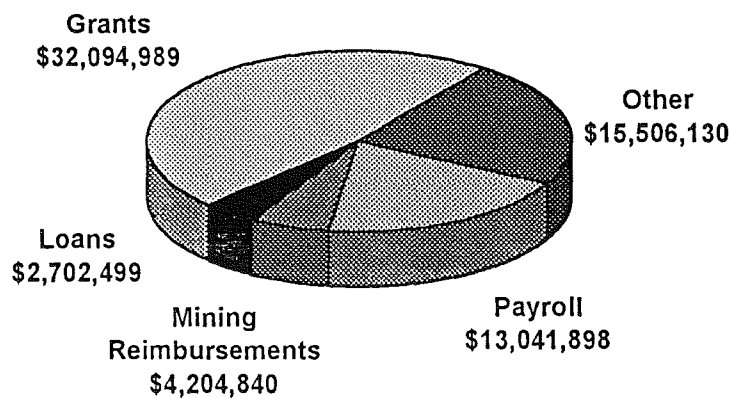
Figures 1-1 and 1-2 summarize the significant financial activity of the IRRRB for fiscal years 1991 through 1993.

**Figure 1-1: Financial Sources
FY91 - FY93**



Source: Statewide Accounting System, Manager's Financial Report as of September 4, 1993.

**Figure 1-2: Financial Uses
FY 91 - FY 93**



Source: Statewide Accounting System, Manager's Financial Report as of September 4, 1993.

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Chapter 2. Revenue Sources

Chapter Conclusions

The main source of IRRRB funds are taconite production taxes and investment earnings. We found that the IRRRB properly accounted for the receipt, deposit and distribution of taconite production taxes and investment income. However, the IRRRB has not expended \$890,000 from a 1987 General Fund appropriation. We believe that the IRRRB should cancel the remaining unspent appropriation balance, unless it can establish specific authority to spend it.

The taconite production tax was the largest source of IRRRB receipts during fiscal years 1991 through 1993, totaling \$80,478,219, or 69 percent, of all IRRRB receipts. Taconite tax receipts are the main source of funds for the IRRR Board Account and the Taconite Environmental Protection Fund. The IRRRB must deposit the Northeast Minnesota Economic Protection Trust Fund portion of the taconite tax into the corpus of the trust fund.

The IRRRB also receives significant investment income on money it holds within the statewide accounting system. Expendable funds for the Northeast Minnesota Economic Protection Trust Fund come primarily from investment income and loan repayments. The IRRRB is allowed to carry over for future years any unexpended money remaining in the IRRRB accounts at fiscal year end.

Taconite Production Taxes

Mining companies pay taconite production taxes on each ton of taconite produced. The Minnesota Department of Revenue collects the taxes and, based on a complex statutory formula, allocates them to various state and local governmental entities. The IRRRB receives about one third of the taconite taxes the Department of Revenue collects. Revenue calculates and identifies how much each of the specific IRRRB accounts should receive. Table 2-1 shows the amount of taxes IRRRB allocated to its various accounts for fiscal years 1991 through 1993.

We tested the IRRRB taconite tax deposits for fiscal years 1991 through 1993. We compared these deposits to the Department of Revenue taconite tax allocation worksheets. We noted no exceptions during our testing.

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Table 2-1
Allocation of Taconite Production Taxes

Account Name	FY91	FY92	FY93
IRRR Board Account	\$ 3,800,971	\$ 3,790,599	\$ 3,777,759
Taconite Environmental Protection Fund	15,352,862	17,618,006	14,604,537
Northeast Minnesota Economic Protection Fund (corpus)	5,497,261	6,686,660	5,144,724
Taconite Economic Development Fund	<u>0</u>	<u>0</u>	<u>4,204,840</u>
Total	<u>\$24,651,094</u>	<u>\$28,095,265</u>	<u>\$27,731,860</u>

Source: Minnesota Department of Revenue Taconite Tax Distribution Flowcharts for fiscal years 1991 - 1993.

Mining Company Reimbursements

In 1992, the Legislature created the Taconite Economic Development Fund, pursuant to Minn. Stat. Section 298.227. Under the law, the IRRRB receives 10.4 cents from mining companies per taxable ton. The IRRRB deposits these receipts into separate accounts for each mining company within the Taconite Economic Development Fund. During fiscal year 1993, the first year the law was in effect, the IRRRB received \$4,204,840 for the Taconite Economic Development Fund. The IRRRB holds the money for the mining companies until it receives written authorization to release the money from a joint committee created by that company. The mining companies must request the money within two years of its deposit. The IRRRB may release the money back to each mining company only for specific projects, including:

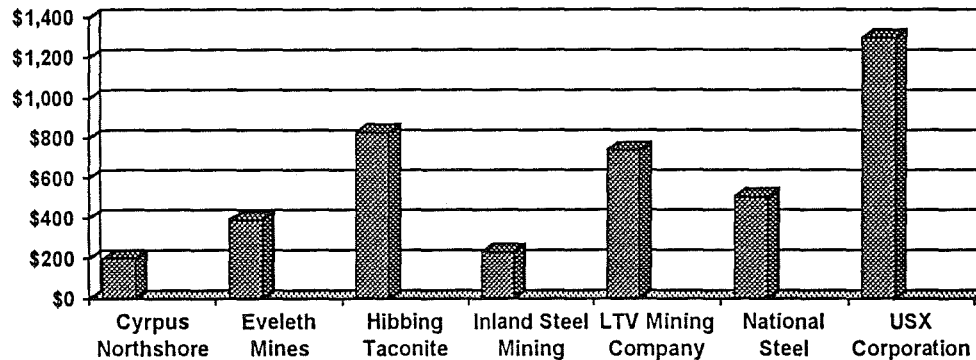
- acquisition of equipment and facilities for the producer, or
- research and development in Minnesota on new mining, or
- taconite, iron, or steel production technology.

Any portion of the funds remaining beyond two years of its deposit reverts to the IRRRB. After two years, the IRRRB can allocate any remaining money to the Taconite Environmental Protection Fund and the Northeast Minnesota Economic Protection Fund.

Currently, seven mining companies contribute to the Taconite Economic Development Fund. For the fiscal year ending June 30, 1993, the IRRRB released the total amount collected from the seven companies. No residual remained in the accounts at the end of fiscal year 1993. Figure 2-1 shows the amount the seven mining companies paid for fiscal year 1993.

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**Figure 2-1: Taconite Economic Development Fund
Taxes Paid Fiscal Year 1993
(in thousands)**

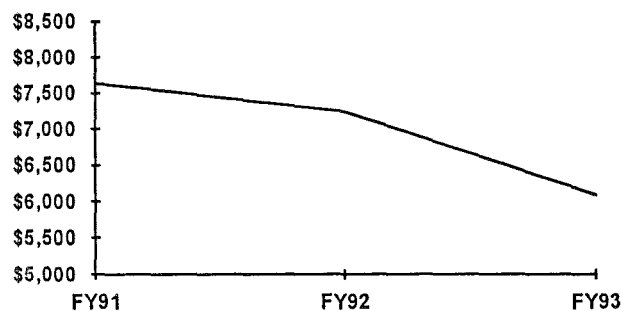


Source: Statewide Accounting System, Manager's Financial Report as of September 4, 1993.

Investment Income

Another major revenue source for the IRRRB is its investment income. The IRRRB does not actively invest its funds. Rather, the Minnesota State Board of Investment invests whatever cash IRRRB has available within the statewide accounting system. The Minnesota Department of Finance calculates and distributes the interest to the IRRRB every month. The IRRRB adds the net interest amount to the fund from which it was earned. Figure 2-2 shows the IRRRB's investment income during fiscal years 1991, 1992, and 1993.

**Figure 2-2: Investment Income
(in thousands)**



Source: Statewide Accounting System, Manager's Financial Report as of account close, 1993, 1992, and 1991.

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General Fund Appropriation

During the audit period, the IRRRB did not receive any appropriations from the state's General Fund. However, in the past, the Legislature has, on occasion, appropriated General Fund money to the IRRRB for specific purposes. One such appropriation occurred in 1987, when the Legislature appropriated \$4 million to the IRRRB from the General Fund for technologically innovative businesses. Although the appropriation was made over six years ago, the IRRRB still has approximately \$890,000 on hand from the appropriation.

1. IRRRB has not expended \$890,000 from a 1987 General Fund appropriation.

The IRRRB has not spent its remaining 1987 appropriation amount. Laws of Minnesota 1987 included an appropriation from the General Fund of \$4 million for technologically innovative businesses. The laws directed the IRRRB to disburse loans, loan guarantees, interest buy-downs, or other forms of participation with private sources of financing. The IRRRB has the authority to reuse any principal and interest received in repayment of loans granted under this appropriation.

The IRRRB initially disbursed approximately \$3.1 million of this appropriation. Then, in 1989, the IRRRB approved a grant and loan package to a Canadian lumber company for the remaining balance of the appropriation. Since the company did not have an affirmative action plan as required, the IRRRB would not release the funds. The money remains encumbered on the statewide accounting system. Minn. Stat 16A.28 states:

On September 1 all allotments and encumbrances for the last fiscal year shall be canceled unless an agency head certifies to the commissioner that there is an encumbrance for services rendered or goods ordered in the last fiscal year.

Since over six years have elapsed since the original appropriation, we question the legitimacy of the encumbrance and whether it still is a valid commitment.

Recommendation

- *The IRRRB should cancel the remaining unspent appropriation balance unless it can establish specific authority to spend it. If the IRRRB has the authority to use the remaining appropriation, it should make arrangements to find an eligible business and disburse the funds.*

Chapter 3. Grants

Chapter Conclusions

The IRRRB disbursed over \$32 million in grants during fiscal years 1991 through 1993. We found three weaknesses in the IRRRB grant process:

- The IRRRB departed from the grant guidelines without adequate justification.*
- The IRRRB has not sufficiently controlled grants made from the Research and Planning Division.*
- The IRRRB funded a project outside the taconite relief area.*

The IRRRB funds three special grant programs; the Storefront Renovation Program, the Business Development Program for Municipal Buildings, and the Endowment Grant Program. Under these programs, the IRRRB distributes funds to intermediate government or nonprofit organizations. These organizations, in turn, award grants or loans to local businesses.

The purpose of the IRRRB grant program is to leverage local, state, federal, and private funds to support community development and economic growth within the taconite tax relief area. The IRRRB has several divisions which process grants, including the Community Development, Economic Development, Tourism, Trails, Mineland Reclamation, and Research and Planning Divisions. These divisions are responsible for maintaining controls over the grant application, approval and disbursement process. Table 3-1 shows the sources of funding for the IRRRB grant programs during fiscal years 1991 through 1993.

Table 3-1: Grant Funding Sources
FY 91 - 93

<u>Account</u>	<u>Percent</u>
Taconite Environmental Protection Fund	55%
IRRR Board Account	28%
Northeast Minnesota Economic Protection Trust Fund	13%
Other	<u>4%</u>
Total	<u>100%</u>

Source: Statewide accounting system information.

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The statute governing the Northeast Minnesota Economic Protection Trust Fund does not provide the IRRRB with explicit authority to make grants from the fund. However, Minn. Stat. Section 298.292, Subd. 2 states "Money in the Northeast Minnesota Economic Protection Trust Fund may be used for the following purposes: (1) to provide loans, loan guarantees, interest buy-downs and *other forms of participation with private sources of financing . . .*" The IRRRB, with legal advice, has interpreted this statute section to include awarding grants from the Northeast Minnesota Economic Protection Trust Fund.

Grant Awarding

The statutes do not provide much specific guidance to the IRRRB concerning criteria for awarding grants. The statutes are vague and subject to broad interpretation. As a result, the IRRRB staff has developed internal grant guidelines to aid in evaluating grant requests. The IRRRB staff believes that these guidelines are not binding and stated that the guidelines are used mainly as a screening tool. According to the Introduction to the Grant Guidelines, "Funds for this grants program are provided through the Taconite Area Environmental Protection Fund and IRRR Board Account." The board has not formally approved the guidelines.

The grant guidelines state that no grant award for any single project can exceed \$250,000 in any single funding cycle. In addition, the guidelines specify certain ineligible project categories, including:

- administrative costs
- city or county owned medical facilities
- electrical power distribution systems
- engineering architectural fees in excess of 10 percent of the project costs
- engineering studies
- feasibility studies
- grant writing costs
- housing
- landfills
- social programs

The IRRRB evaluates grant applications based on the grant guidelines. The guidelines require applicants to address the following: jobs, leverage, relative need, impact, and project viability. After the IRRRB approves an initial project profile, the applicant prepares a formal project application. The IRRRB commissioner and staff review and compare the various applications. In most cases, the commissioner compiles a list of projects and recommends them to the IRRR board. The board generally takes action on individual grant proposals.

The IRRRB reimburses grantees based on invoices submitted for eligible expenses. The guidelines state that the IRRRB will not make payments until the grantee submits invoices for work performed in accordance with the grant agreement.

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2. The IRRRB departed from the grant guidelines without adequate justification.

The IRRRB disbursed grants for projects that the guidelines classified as ineligible categories. In addition, the IRRRB funded at least two projects that did not follow the formal grant application process.

The IRRRB approved at least two projects through the Community Development Division in categories which the grant guidelines cite as ineligible. We saw no evidence that the IRRRB considered the grant guidelines when approving these grants, or documented the reasoning behind its funding decision. In one case, the IRRRB disbursed a grant of \$150,000 to the U.S. Hockey Hall of Fame. According to the grant agreement, the grant included \$93,000 for short and long term debt retirement, \$25,000 for various past due vendor accounts, and the remaining amount to help defray various operational expenses, including salaries, office expenses, promotion, maintenance, and special events. In another case, the IRRRB provided a "cash flow infusion" to CWDC Industries Inc. to meet current payroll and other expenses. It does not appear that any of these grants were eligible under the current guidelines.

In addition, the IRRRB awarded the grants to both the Hockey Hall of Fame and CWDC Industries without requiring the applicants to go through the standard grant application process. Instead, the grantees submitted memos to the IRRRB requesting funds. The correspondence on file for these grants did not address all of the grant requirements outlined in the grant program guidelines.

Because of the lack of definitive guidance within the statutes, we believe the established IRRRB guidelines concerning grants are extremely important. We believe these guidelines should be formally approved by the IRRR Board. The Board should be aware of the standards established by the IRRRB in determining eligible grant projects. Finally, to ensure fair treatment for all applicants, we believe that it is important that the IRRRB formally document its justification for approving grants that deviate from its formal guidelines.

Recommendation

- *The IRRRB should develop a formal process for waiving guideline provisions. The IRRRB should document its justification for approving projects that deviate from the established guidelines.*

3. The IRRRB has not sufficiently controlled grants made from the Research and Planning Division.

There are no specific grant guidelines for Research and Planning Division grants. IRRRB staff indicated that Research and Planning projects, which are funded from the IRRR Board account, need not comply with the established grant guidelines.

Guidelines are important for the Research and Development grants, because the board does not approve them individually. Rather, the board approves an annual grant and loan budget for the division. The board allows the Research and Planning Division, with the approval of the

Iron Range Resources and Rehabilitation Board

commissioner, to award individual grants and loans without further board action. The board does not review or approve individual projects on a project by project basis, either before or after they are awarded.

The guidelines should establish specific selection criteria and dollar limits per project. Guidelines are needed to ensure that the Research and Planning projects complement, rather than duplicate or conflict with other IRRRB grant and loan programs. We believe the guidelines should be formally approved by the IRRR Board. The board should be aware of the standards established by the IRRRB in determining eligible grant projects. The IRRRB staff should periodically report to the board regarding the specific projects funded through Research and Development.

Recommendation

- *The IRRRB should develop Research and Planning project guidelines. The guidelines should address project selection criteria and dollar amount limits. The IRRRB staff should periodically provide the IRRR Board with information regarding the specific projects funded through the Research and Planning Division.*

4. The IRRRB funded a project outside the taconite tax relief area.

During our audit period, the IRRRB funded a project that was located outside of the taconite tax relief area. The IRRRB funded an environmental conference held in Duluth. The offices of the sponsoring organization were located in International Falls. Both International Falls and Duluth are outside of the taconite tax economic relief area as defined by statute. IRRRB officials told us that they approved the conference because the agenda included post conference tours and activities in Northeast Minnesota. However, it does not appear that the final posted conference program included any type of field trips into the taconite relief area.

The grantee received a grant for \$10,000 during fiscal year 1991. The IRRRB subsequently loaned the same grantee \$25,000 in additional funds. Ultimately, the commissioner determined the loan to be uncollectible.

The IRRRB funded this project out of the IRRR Board account. Minn. Stat. Section 298.22 governs this account. The statute clearly states that projects must relate to the taconite tax relief area. However, as shown in Table 3-2, the statutes are inconsistent as to whether the IRRRB must spend its funds either **within** or **for the benefit of** the taconite relief area. IRRRB personnel believe that Minnesota Statute 298.28 subd. 7 modifies the IRRR Board account statutory language to include projects for the benefit of the tax relief area. We saw no evidence that the conference specifically benefited the taconite relief area.

Recommendation

- *The IRRRB should ensure that projects benefit the taconite relief area pursuant to Minnesota Statutes.*

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**Table 3-2: Project Funding
Taconite Relief Area Statutory Language**

MSS 298.2211 Subd. 2 - Board Account: "Projects undertaken, developed, or financed pursuant to this section shall be located within the tax relief area."

MSS 298.28 Subd. 7 - Allocation of production tax to the IRRRB board account: "...the amount distributed pursuant to this subdivision shall be expended within or for the benefit of the tax relief area....."

MSS 298.2213 - Northeast Minnesota Economic Development Fund: "Money appropriated in this section must be expended only in or for the benefit of the tax relief"

MSS 298.223 - Taconite Environmental Protection Fund: " The fund is created for the purpose of reclaiming, restoring and enhancing those areas of northeast Minnesota located within the tax relief area"

MSS 298.291 - Northeast Minnesota Economic Protection Trust Fund: "Money from the trust fund shall be expended only in or for the benefit of the tax relief area."

Source: 1992 Minnesota Statutes.

Special Grant Programs

The IRRRB has funded a number of special grant programs. Under these programs, the IRRRB awards grants to communities, giving them the responsibility for administering the funds. The communities determine individual projects and subgrant the original IRRRB grant to others for specific projects. The IRRRB currently has three grant programs which operate in this manner. They are the Storefront Renovation Grant Program, the Business Development Program for Municipal Buildings, and beginning in fiscal year 1994, the Endowment Grant Program. Table 3-3 shows grants awarded under these programs during fiscal years 1991 through 1993.

**Table 3-3: Special Grants Awarded
Fiscal years 1991 - 1993**

Program	FY 91	FY 92	FY 93
Storefront Renovation	\$600,000	\$300,000	\$ 300,000
Municipal Buildings	\$200,000	\$476,000	\$1,588,000*

* \$948,000 subsequently canceled and not disbursed.

Source: IRRRB internal records.

Under the Storefront Renovation Grant Program, the IRRRB disburses grants to various communities for storefront renovation. The communities, in turn, provide low-interest loans to specific local businesses. The loan repayments remain with the city to be used for other economic development projects.

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The Business Development Program for Municipal Buildings provides grant funds to communities for renovation of municipal buildings. Under this program, once the community has completed the renovation project, it leases space within the municipal building to private businesses. The businesses remit lease payments, which the community can use for other economic development projects.

Finally, the IRRRB began awarding endowment grants in fiscal year 1994. The IRRRB has established guidelines to provide grants to eligible community foundations. The purpose of the endowment grants are to promote economic development projects within the community. The recipient must retain the IRRRB grant in the corpus of an endowment fund and use only the earnings generated by that portion of the corpus. The community may only use the money for projects which would be eligible for funding under Minn. Stat. Section 298.22. To date, the IRRRB has disbursed endowment grants of \$50,000 to the Virginia foundation and \$25,000 to the Chisholm foundation.

Chapter 4. Loans

Chapter Conclusions

As of June 30, 1993, the IRRRB had \$10 million in outstanding loans. We found one weakness in the way the IRRRB awards loans:

- The IRRRB departed from its loan guidelines without establishing adequate justification.*

We also found two weaknesses in the IRRRB procedures concerning delinquent loans:

- The IRRRB did not adequately monitor delinquent bank participation loans.*
- The IRRRB did not obtain board approval before allowing a foreclosed loan to be taken over by a third party.*

As a part of its mission to enhance the economic vitality of the taconite relief area, the Iron Range Resources and Rehabilitation Board (IRRRB) administers a business loan program. As of June 30, 1993, the IRRRB outstanding loan balance was \$10,083,492, of which the IRRRB funded \$1,361,233 from the IRRR Board account and \$8,722,259 from the Northeast Minnesota Economic Protection Trust Fund. Table 4-1 shows cumulative loan activity during fiscal years 1991 through 1993.

Table 4-1
Loan History
Cumulative fiscal years 1991 - 1993

Loans outstanding at July 1, 1990	\$11,544,777
New loans disbursed:	
Approved fiscal years 1991-1993	2,452,500
Approved before fiscal year 1991	250,000
Loan principal repayments	(4,520,780)
Loan cancellations and write-offs	(406,184)
Other	<u>763,179</u>
Loans outstanding at June 30, 1993	<u>\$10,083,492</u>

Source: IRRRB detail supporting Fund 24 and 58 fiscal year 1991, 1992, and 1993 financial statements.

The IRRRB loan program consists of both bank participation loans and direct loans to various businesses. In a participation loan, the IRRRB purchases up to fifty percent participation in a loan, with the remainder funded by a bank. The IRRRB and the bank sign a participation agreement which details the responsibilities of both parties, and the understanding of the timing

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and amount of repayments. A statutory formula determines the amount of interest the IRRRB charges on its portion of the loan. The bank negotiates directly with the loan applicant for the interest rate on its portion. For participation loans, the IRRRB relies on the bank to determine appropriate levels of loan collateral and to perfect any liens.

In a direct loan, the IRRRB disburses the loan directly to businesses without any bank involvement. In those cases, the IRRRB is responsible for determining the level of collateral and perfecting any liens. The IRRRB takes on more responsibility and risk when entering into direct loans. During our audit scope, the IRRRB disbursed thirteen bank participation loans and four direct loans.

Loan Issuance

During fiscal years 1991 to 1993, the IRRRB approved seventeen loan projects totaling \$2,452,500. Of those seventeen projects, the IRRRB funded fifteen out of the Northeast Minnesota Economic Protection Fund and two out of the IRRR Board account. Table 4-2 presents details on these seventeen loans.

Table 4-2
Loans Issued
Fiscal years 1991 - 1993
(as of June 30, 1993)

Fiscal Year	Account	Project Name	IRRRB Loan Amount	Loan Type
1991	NE MN Economic Protection Fund (NEMEPPF)	Kasson Manufacturing	\$ 75,000	Direct
1991	NEMEPPF	Precision	\$ 20,000	Participation
1991	NEMEPPF	Jaaco Incorporated	\$ 50,000	Participation
1991	NEMEPPF	Hedstrom Lumber Company, Incorporated	\$250,000	Participation
1992	NEMEPPF	Pelican Lake Land & Lumber	\$117,500	Participation
1992	NEMEPPF	Improvement Limited Partnership	\$500,000	Participation
1992	NEMEPPF	Mountain Inn Lutsen	\$175,000	Participation
1992	NEMEPPF	Midland Standard Incorporated	\$250,000	Participation
1992	NEMEPPF	Arrowhead Promo	\$210,000	Participation
1992	NEMEPPF	Minnesota Diversified Industries	\$225,000	Direct
1992	IRRR Board Account	Northern Resources Alliance	\$ 25,000	Direct
1992	NEMEPPF	Lupin Inc. Motel	\$ 50,000	Participation
1992	NEMEPPF	Vermilion Community College Foundation	\$ 25,000	Participation
1992	NEMEPPF	Pal Pak Incorporated	\$ 10,000	Participation
1993	NEMEPPF	Cetane Technology Incorporated	\$200,000	Participation
1993	NEMEPPF	Minnesota Twist Drill	\$250,000	Participation
1993	IRRR Board Account	Fire Flight, Incorporated	\$ 20,000	Direct

Source: Statewide Accounting System.

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The IRRRB Economic Development Division is responsible for maintaining controls over the loan application, approval, and disbursement processes. The IRRRB has a formal loan application process. Applicants complete a loan pre-application. The Economic Development Division reviews the pre-applications to determine project eligibility. After the division approves a pre-application, the applicant completes the regular loan application. The loan applications go through a formal review process. Specific parties must approve the loans, depending on the source of the loan funds. Table 4-3 outlines the parties involved in the approval process for both the IRRR Board account and the Northeast Minnesota Economic Protection Trust Fund.

Table 4-3
Parties involved in loan approval

<u>IRRR Board Account</u>	<u>Northeast Minnesota Economic Protection Fund</u>
IRRRB Economic Development Division	IRRRB Economic Development Division
IRRR Board	Technical Advisory Committee
	IRRR Board
	Legislative Advisory Committee (until May 1993)
	Governor

Source: Minn. Stat. and internal discussion with IRRRB staff.

Until May 1993, the state Legislative Advisory Committee reviewed the Northeast Minnesota Economic Protection Fund loans and grants prior to sending them to the governor. However, a statutory amendment in 1993 deleted this step in the approval process.

Table 4-4 Loan Guidelines

Eligible	Ineligible
Businesses <ul style="list-style-type: none">• manufacturing/assembly• tourism projects which attract tourism expenditures from outside the region• technologically innovative industries	Businesses <ul style="list-style-type: none">• agricultural• construction• media• professional offices• retail/service• speculative real estate• transportation
Uses <ul style="list-style-type: none">• building renovation• inventory purchase• land and building acquisition• land improvements• new building construction• purchase of machinery and equipment• working capital (not involving line of credit)	Uses <ul style="list-style-type: none">• debt refinancing• acquisitions of existing business

Source: IRRRB loan guidelines

Although the statutes give the IRRRB the authority to make loans from both the IRRR Board account and the Northeast Minnesota Economic Protection Trust Fund, the statutory language is

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broad and vague concerning what types of projects the IRRRB can fund. As with the grant programs, the IRRRB has established internal guidelines for its bank participation loans. The IRRRB does not consider the loan guidelines to be binding, similar to the grant guidelines. In addition, the board has not formally approved the guidelines. The IRRRB does not have any formal guidelines in place for direct loans. The guidelines also set the maximum IRRRB participation at \$250,000 for any single project. Table 4-4 cites eligible and ineligible businesses and uses of loan funds, according to the guidelines.

In general, the IRRRB has controls in place to ensure only eligible applicants receive funding. However, the IRRRB does not always follow its guidelines when determining a project's eligibility or loan amount.

5. The IRRRB departed from its loan guidelines without establishing adequate justification.

The IRRRB funded projects that did not meet its loan program guidelines. The IRRRB disbursed loans to applicants for motel renovation, acquisition of an existing business, and an airline charter service. The IRRRB participation loan guidelines describe these types of businesses as "followers" of the economy and ineligible for assistance under the loan program.

In one example, the IRRRB funded a motel renovation project in direct conflict with the loan program guidelines. The IRRRB participated in a loan for the renovation of a motel located in Hibbing, Minnesota. The IRRRB contributed \$500,000 of a \$1,000,000 loan. The amount of the loan exceeded the maximum amount established by the guidelines. In addition, the guidelines state that service industries are ineligible businesses. Tourism projects must attract tourism expenditures from outside the region. Hotel projects appear to be service related and do not, in and of themselves, bring tourists to the region. IRRRB staff had not documented reasons for funding the project nor did they formally communicate to the board that the project deviated from the established guidelines.

In another example, the IRRRB loaned funds to a corporation to purchase an existing business. The IRRRB provided \$250,000 of a total loan for \$550,389. The corporation acquired the assets of a failing research center located within the taconite relief area. The IRRRB guidelines disallow acquisitions of existing businesses as uses of loan proceeds. This project was approved by the IRRR board, the Legislative Advisory Committee, and the governor. Again, the IRRRB had no documentation to justify its departure from the guidelines.

In yet another example, the IRRRB disbursed both grant and loan funds to purchase the Ely airport fixed air base operation. The IRRRB gave a loan of \$25,000 and a grant of \$62,500 to the Vermilion Community College Foundation. The foundation operated the charter service and provided inflight training for the Vermilion Community College aviation program. The project clearly identified the rental of aircraft to the U.S. Fish and Wildlife Service, International Wolf Center, charter flights, and rental of airplanes to individuals in the Ely area as a major part of the project. Because this was a transportation project, it was ineligible under the current guidelines.

Because of the lack of definitive guidance within the statutes, we believe that it is important for the IRRRB to have formal, established guidelines concerning approval of loans. We believe these

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guidelines should be formally approved by the IRRR Board. The Board should be aware of the standards established by the IRRRB in determining eligible loan projects. Finally, to ensure fair treatment for all applicants, we believe that it is important that the IRRRB formally document its justification for approving loans that depart from its formal guidelines.

Recommendations

- *The IRRRB should establish formal, separate guidelines for its direct loan program. The IRRR Board should formally approve the IRRRB loan guidelines. The IRRRB should develop a formal process for waiving guideline provisions. The IRRRB should document its justification for approving projects that deviate from the established guidelines.*

Loan Repayments

The IRRRB received about \$4.5 million in loan principal and \$1.5 million in interest on loans during fiscal years 1991 through 1993. For direct loans, the IRRRB retains full responsibility for collecting and pursuing repayments from borrowers. In the case of foreclosure, the IRRRB is responsible for asset liquidation and distribution.

However, for bank participation loans, the IRRRB delegates collection responsibility to the participating bank. The bank collects payments from borrowers and remits the agreed upon portion to the IRRRB. For participation loans, the bank also performs any necessary collection attempts for delinquent accounts. Finally, the bank becomes responsible for asset liquidation and distribution if foreclosure occurs. We noted the following weaknesses in the manner in which IRRRB handled delinquent loans.

6. The IRRRB did not always adequately monitor delinquent bank participation loans.

The IRRRB did not contact the participating bank timely when loans became delinquent. The IRRRB relies on banks to perform any necessary collection action on delinquent participation loans. However, since the IRRRB is still responsible for its delinquent loans, it has a responsibility to monitor the bank's collection efforts.

In one case, the participating bank liquidated the assets of a delinquent borrower without IRRRB staff approving the terms of the sale. IRRRB staff were aware of an impending sale of the property. However, the IRRRB was not involved in the final negotiations, and did not agree to the terms of the sale before it occurred. The IRRRB received a \$1,400 payment from the bank for the sale of the foreclosed property. The IRRRB wrote off the remaining loan balance of \$100,201. Although the IRRRB did not expressly agree to the terms of the sale, it concluded that the sale was the best resolution for all parties.

With other delinquent loans, the IRRRB did not always contact the participating bank timely concerning their status. In one case, the IRRRB did not contact the bank until seven months after the loan payment was due. Since the bank had a malfunction in its loan receivable system, it had not identified the loan as delinquent. In another case, the IRRRB had not contacted the bank even though five months had elapsed and the bank had not sent the required payment. The

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IRRRB needs to be more conscious of collection efforts taken by the bank. The IRRRB should contact banks within reasonable time frames to determine the status of any delinquent bank participation loans.

Recommendation

- *IRRRB should contact the bank promptly when a bank participation loan becomes delinquent.*

7. The IRRRB did not obtain board approval before allowing a foreclosed loan to be taken over by a third party.

The IRRRB did not obtain approvals from the IRRR Board before allowing third parties to purchase bank participation loans. Minn. Stat. Sections 298.22 and 298.26 require the IRRR Board to approve all new loans. The board did not approve any of the five loans which were sold to third parties. Instead, the Economic Development Division approved the new borrower and the new loan provisions. In each of these cases, the IRRRB wrote off a substantial loan balance as part of the restructuring, ranging from \$44,000 to \$166,000. We believe that there should be a more formal approval process for each restructured loan, even though the approval may come after the fact. In addition, IRRRB should ensure that the bank is using a fair and equitable means of selling the assets of foreclosed properties.

Recommendations

- *IRRRB should establish an approval process at the board level for all loans sold to third parties.*
- *IRRRB should ensure the bank is obtaining the best value on the loans and also is using a fair and equitable means of selling the property.*

Chapter 5. Foreclosed Property

Chapter Conclusions

The IRRRB owns three parcels of foreclosed property, the Coates Plaza Hotel, the Olcott Plaza building, and the Hibbing chopsticks factory. The IRRRB has contracted with Bowman Corporation to manage both the Coates Hotel and the Olcott Plaza. We believe that the IRRRB needs to improve its monitoring of these management service agreements.

The IRRRB currently hold three parcels of foreclosed real estate. Table 5-1 shows the parcels and their current carrying values. The IRRRB obtained these parcels as a result of past revenue bond issuances. Pursuant to Minn. Stat. 298.2211, the IRRRB has the authority to issue revenue bonds and other debt obligations to generate revenue or to provide financing. The IRRRB currently does not have any revenue bond debt outstanding nor did it have such activity during our audit period.

Table 5-1
IRRRB Property Held for Resale

Description of Property	Carrying Value
Coates Plaza Hotel	\$2,315,104
Olcott Plaza	\$1,147,924
Chopsticks Factory	\$2,197,000

Source: Fixed Asset Records for the Northeast Minnesota Economic Protection Fund included in Minnesota Annual Financial Statements as of June 30, 1993.

Coates Plaza Hotel

The Coates Plaza Hotel is located in downtown Virginia, Minnesota. A developer purchased the Coates Hotel in the early 1980s. The IRRRB issued revenue bonds for approximately one half of the new construction and renovation costs. The project faltered in 1989 and the IRRRB took over the property. On September 27, 1990, the IRRRB entered into an agreement with another purchaser for the Coates Plaza Hotel for \$2,300,000. The IRRRB foreclosed on this company in March 1993 and again took over the property.

After the foreclosure, the IRRRB enlisted the management services of Bowman Corporation to manage the hotel. The Bowman Corporation is a Duluth-based property management service. The hotel employees are employees of the Bowman Corporation. The IRRRB pays Bowman a monthly management fee of \$3,000. Bowman opened two bank accounts in Virginia for payroll and general operations. The daily receipts and expenditures are run through the operating account at the local bank. A Bowman representative reviews and approves hotel expenditures weekly. A Duluth accounting firm compiles monthly financial statements for the hotel. The

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IRRRB Economic Development Division receives the monthly statements, but has not performed any operational reviews of the hotel's financial activity.

Olcott Plaza

The Olcott Plaza is an office building located in Virginia, Minnesota. It initially was a medical clinic and the IRRRB issued revenue bonds for it in 1985 as part of a financing package. Medical Park Partnership Limited leased the building. In 1987, the lessee fell delinquent on its lease payments. In late 1989, the IRRRB terminated the lease and took possession of the building. At that time, the IRRRB remodeled the building. Bowman Corporation served as a construction consultant beginning in May 1988 and as building manager beginning on January 1, 1989, when the first tenants moved in. There are currently 12-15 tenants of the building, with over half being state agencies. The Bowman Corporation pays most of the Olcott Plaza operating costs directly and then obtains reimbursement from the IRRRB. Lessees remit lease payments directly to the IRRRB.

The management agreement for the Olcott Plaza expired on January 1, 1994 and was extended through June 30, 1994. It provides for a monthly base management fee of \$1,147, reimbursable operating expenses of approximately \$13,000 monthly, and an additional management fee of \$25 per month for the interest attributable to any money Bowman advances for office building expenses each month.

Chopsticks Factory

In the early 1980s, the IRRRB was aiding the development of the wood industry. The IRRRB set up a lease purchase agreement to finance a chopsticks factory within the Hibbing Wood Industrial Park. As part of the package, the IRRRB issued \$3.4 million in industrial revenue bonds. However, the project failed and the lease payments became delinquent. The IRRRB canceled the lease agreement and took over the collateral; the factory building and its equipment. For two years, the IRRRB attempted to find another buyer. It eventually liquidated the assets and sustained a \$3 million loss on the sale of the equipment. The IRRRB has been unable to sell the building and currently hold title to it.

We examined the Bowman Corporation management service agreements over the operations of the Coates Plaza Hotel and the Olcott Plaza. During our review, we noted weaknesses in the way the IRRRB handles its management agreements with the Bowman Corporation.

8. The IRRRB did not properly monitor certain aspects of its management service agreements with the Bowman Corporation.

The IRRRB has not enforced all provisions of its management service agreements with the Bowman Corporation. In addition, the IRRRB has not performed detailed reviews of the Coates Hotel financial activity.

Upon review of the financial invoices for the Olcott Plaza, we identified reimbursements of management personnel transportation. There is inconsistent information within the management service agreement as to whether travel costs are reimbursable. The IRRRB reimbursed \$1,914 in mileage between July 1991 and February 1994.

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We also noted the city water bills relating to the Olcott Plaza are three months in arrears. Pursuant to Minn. Stat. Section 16A.124, state agencies must pay each valid obligation within any discount period or within 30 days, whichever is earlier. Since the Olcott Plaza is state owned, the bills for such property need to be paid timely. The IRRRB staff should question any costs clearly marked "in arrears". The IRRRB should ensure payments are made in accordance with applicable legal requirements.

In addition, the Olcott management agreement requires the Bowman Corporation to provide certificates of insurance. The IRRRB has not enforced this contract provision and has not verified whether the company is adequately insured.

Finally, the IRRRB has not performed adequate reviews of the operating records of the Coates Hotel. The Bowman Corporation directly pays for all operating expenses of the hotel. IRRRB staff performs monthly analyses of the hotel's overall financial statements. However, the IRRRB has not established any periodic, detailed financial review of the Coates Hotel financial transactions to verify their propriety.

Recommendations

- *The IRRRB should enforce all management service agreement provisions. The IRRRB should and seek repayment for any unallowable reimbursed expenses, if necessary.*
- *The IRRRB should improve its monitoring of the Coates Hotel operations.*

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Chapter 6. Payroll and Other Administrative Disbursement Issues

Chapter Conclusions

The IRRRB properly processes and controls its payroll transactions. However, one issue came to our attention concerning other administrative disbursements. On the issue, we concluded that the IRRRB improperly reimbursed a contractor for certain expenses.

Employee payroll expenditures during our audit period totaled \$13,041,898. Table 6-1 provides a summary of the IRRRB payroll expenditures by program division. The IRRRB has approximately 90 full time employees year round. During the tourist seasons at Giants Ridge and Iron World, the IRRRB employs approximately 30-40 additional part-time workers.

Table 6-1
Payroll Costs by Division

Division	1993	1992	1991
Building Demolition	\$ 267,061	\$ 249,619	\$ 240,172
Community Development	236,824	253,696	340,659
Economic Development	315,471	302,916	297,688
General Support	1,124,115	939,700	822,962
Giants Ridge	728,115	784,706	754,645
Iron World	923,362	962,649	956,503
Mineland Reclamation	204,151	187,797	151,979
Iron Range Research & Interpretive Center	425,155	394,714	411,092
Tourism	182,674	145,964	115,909
Trails	118,930	105,370	97,300
Total	<u>\$4,525,858</u>	<u>\$4,327,131</u>	<u>\$4,188,909</u>

Source: Statewide Accounting System, Manager's Financial Report as of close for FY91, FY92, and FY93.

During our audit, two additional issues concerning administrative costs came to our attention. These issues both relate to improper reimbursements of expenses.

9. The IRRRB improperly reimbursed a contractor for certain expenses.

The IRRRB reimbursed a consultant for expenses which were not allowable under the contract. The consultant performed business recruitment work for the IRRRB. The IRRRB paid the consultant for certain expenses that were not allowable under the contract with the IRRRB, including four Vikings tickets totaling \$100. The consultant claimed the tickets were given to two different vendors to promote economic development on the Iron Range. The IRRRB also reimbursed the consultant for meals and other expenses. If these expenses were necessary, the

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IRRRB should have amended the consultant's fiscal year 1993 contract. If not, the IRRRB should not have reimbursed the expenses.

Recommendation

- *The IRRRB should reimburse contractor expenses in accordance with the related contracts.*
- *The IRRRB should review the expense reimbursements made to the consultant and determine whether the consultant should repay any of the expense reimbursements.*

DATE : August 2, 1994

TO : Office of the Legislative Auditor
Members of the Legislative Audit Commission

FROM : Jim Gustafson
Commissioner



PHONE : (218) 749-7721

FAX : (218) 749-9665

SUBJECT : **RESPONSE TO IRRRB FY 91-93 AUDIT**

The following is the IRRRB's response to the FY 91 - 93 Audit of the IRRRB performed by the Office of the Legislative Auditor, Findings 1 - 9 and accompanying recommendations:

1. IRRRB has not expended \$890,000 from a 1987 General Fund appropriation.

As the audit finding explains, this is money for a grant and loan package negotiated with a Canadian lumber company that invested over \$80 million to build a parallel-strand lumber manufacturing facility in Deerwood which now employs approximately 145 people in the plant and another 200 in the woods. Consequently, it remains a valid commitment that the IRRRB will honor once the company has complied with all conditions of the project grant and loan package, including their affirmative action certification, which the company continues to work on.

Yet, the IRRRB acknowledges that this process has taken too long, and, therefore, agrees to set a deadline of December 31, 1994, for the company to obtain its affirmative action certification in the State of Minnesota and consummate all necessary agreements required to trigger the release of the IRRRB commitment. Phil Bakken, Director of Special Projects, will be the IRRRB staff person responsible for resolving this matter.

However, if this deadline is not met, then the IRRRB will seek to use this money for another eligible project as provided by M.S. §298.2213, the statute that created and governs the use of the Northeast Minnesota Economic Development Fund as a standing appropriation to a special fund. This standing appropriation to a special fund is *not subject to cancellation* by virtue of M.S. 16A.28, Subdivision 7.; which provides various exceptions to the provisions of M.S. §16A.28, Subdivision 6., the statute that the audit finding cites as justification to question the legitimacy of the \$890,000 encumbrance.

2. The IRRRB departed from the grant guidelines without adequate justification.

Several points need to be made regarding this finding. First, both of the projects cited in the finding developed outside the IRRRB Grants Program for Governmental Units and Non-profit Organizations. Consequently, the guidelines for this program don't apply to these two projects, and the application process for this program is not relevant; as these two projects

never competed against the rest of the applications submitted during the annual grants cycle for this program.

Secondly, even if one *were* to apply the criteria which are contained in the IRRRB Grants Program for Governmental Units and Non-profit Organizations to these two projects, the IRRRB does not agree that these two projects would be ineligible under those guidelines. The grant awards for these projects helped to defray operational costs that the audit team classified as administrative costs, which *are* specified as ineligible costs in the IRRRB Grants Program for Governmental Units and Non-profit Organization guidelines. However, while administrative costs are not defined in the guidelines, the standard IRRRB interpretation of "administrative costs" has been costs such as applicant staff time and expenses required to make application to the IRRRB, *not the operational expenses paid by the IRRRB grants for these two projects.*

However, while the IRRRB does not agree that it departed from the guidelines in the instances cited, it also understands the spirit of this finding's recommendation regarding deviation from grant guidelines in general and will work on refining its stance on this issue. This discussion will be led by Mike Larson, Planning Grants Coordinator, and involve staff that administer the many IRRRB programs that award grants to units of government and other organizations. Our goal will be to conclude such discussions before January 1, 1995, which is the beginning of the next cycle of the IRRRB Grants Programs for Governmental Units and Non-profit Organizations.

That said, perhaps it's now appropriate to make a philosophical comment which will be revisited later in our response to other findings: As this finding acknowledges, the statutes that govern the IRRRB give the IRRRB Commissioner a great deal of flexibility to take actions "to develop the remaining resources" of the taconite tax relief area. Adherence to guidelines within programs is important in order that all applicants are treated equitably, and the IRRRB completely concurs with the audit findings in this regard. However, the Commissioner must never be constrained by the guidelines of individual programs from taking actions that fall within the parameters of the IRRRB's governing statutes, and that he or she has determined are both necessary and proper to accomplish that mission.

3. The IRRRB has not sufficiently controlled grants made from the Research and Planning Division.

The IRRRB agrees that the IRRRB Research and Planning program has funded a number of diverse projects and activities which to the outside eye may appear to lack focus or control. In a few instances, projects have achieved only partial success or been brought to inadequate closure, and the IRRRB concurs that it needs to improve its oversight and follow-up in this area. However, overall, the program has been beneficial to the agency and its service area.

Regarding this finding's recommendation to develop guidelines for the program and to periodically provide information to the IRRR Board regarding the status of specific projects, it should be noted that the Research and Planning program was originally established as a way to address research, planning or development projects which fall outside the guidelines of other IRRRB programs and the timelines of IRRR Board meetings. Therefore, while the

IRRRB agrees that it will work to develop guidelines for the program, it should be understood that, by definition, these guidelines should be kept simple and flexible.

The IRRRB has always provided any information requested by IRRR Board members concerning specific Research & Planning projects and will continue to do so. (In fact, some Research & Planning projects have been initiated at the request of IRRR Board members.) It's possible that Research & Planning updates could become a regular part of IRRR Board meetings, or at least that information on Research & Planning projects could be regularly provided as a part of IRRR Board packets, leaving the option open to discuss specific projects as needed.

Brian Hiti, Planner Senior, will be responsible for addressing this area of concern and will work with other senior agency staff to develop an action plan regarding the Research & Planning activity prior to the September, 1994, IRRR Board meeting.

4. The IRRRB funded a project outside the taconite tax relief area.

While the audit team focused on the actual location of the event and offices of the grantee, and in discussing the project, IRRRB staff *may have mentioned* that the agenda for the conference in question included post conference tours in the IRRRB service area, the pivotal issue here is really whether the project, as proposed, promised a benefit to the taconite tax relief area. In funding the project, the IRRRB determined that the project did, in fact, promise such a benefit, but not for the reason discussed in the audit finding.

The IRRRB monies provided for this project funded a National Stewardship Conference which included participants and speakers from throughout the state and nation to discuss the environmentally sensitive use of land and other natural resources to support both jobs and quality of life. In so doing, the conference addresses fundamental issues which are integral to the "development of the remaining resources" of the taconite tax relief area. In this way, the project complies with the intent of M.S. §298.22. In fact, considering how important natural resources are to northeastern Minnesota and the conflict that often ensues when new plans to develop such resources are proposed, it could be argued that a conference of this type potentially could provide enormous benefits to the taconite tax relief area.

Regarding the larger issue of ensuring that all its projects benefit the taconite tax relief area pursuant to Minnesota Statutes, the IRRRB unequivocally concurs.

5. The IRRRB departed from its loan guidelines without establishing adequate justification.

This finding cites departures from the loan guidelines in three areas: type of business assisted, the use of the financing provided, and the amount of assistance provided. Let us address each example cited.

The audit team determined that the IRRRB loan to renovate the Kahler Hotel conflicted with the bank participation loan guidelines because it's an ineligible service sector business, but the IRRRB viewed this loan as providing assistance to the tourism industry which attracts

expenditures from outside the region. The greatest tourism impact is provided by visitors that stay overnight in the region. Renovating the Kahler Hotel helps to provide the beds necessary to promote such overnight stays, especially in the Hibbing-Chisholm area. However, the IRRRB agrees that the Kahler loan exceeds the maximum amount specified in the guidelines.

The audit team focused on the fact that the Midland Standard loan involved the acquisition of a business (the former Hanna research laboratory), and, therefore, is ineligible under the uses section of the guidelines, but the IRRRB focused on the project as being a technologically innovative business which supports the regional minerals industry.

The audit team determined that the loan to the Vermilion Community College to support the fixed-based operation (FBO) at the Ely Airport conflicted with the guidelines because it's a transportation business, but the IRRRB again viewed this loan as assistance to the tourism industry which attracts expenditures from outside the region. As noted in the finding, the Ely FBO provides charter service into the American and Canadian wilderness for fly-in fishing and supports the "bush pilot" aviation program at Vermilion Community College that trains individuals to pilot airplanes for such fly-in excursions. Fly-in excursions are an important part of the Ely tourism industry, and, therefore, the IRRRB felt that the project fell within the guidelines.

While the IRRRB disagrees with some of the audit team's determinations regarding specific bank participation loan program guideline deviations, it concurs that the Kahler Hotel loan project did deviate from the guidelines by exceeding the maximum loan amount prescribed in the guidelines. The IRRRB believes that such deviations are, by far, the exception rather than the rule, but will probably occur again to address the individual needs of certain critical projects. Therefore, the IRRRB agrees that it will work to establish policies and procedures to ensure that it clearly informs the Technical Advisory Committee and the IRRR Board when such a deviation is proposed, and that it documents the loan file when such a deviation actually occurs. Rick Anderson, Loan Officer, will work with other Business Development staff to develop such a procedure prior to the September, 1994, IRRR Board meeting.

Regarding direct loans, it should be noted that the agency has made direct loans when the needs of a specific project which the Commissioner has determined is necessary and proper have warranted action and there's no existing program which adequately addresses the project. In this way, the discussion of direct loans runs parallel to the IRRRB's philosophy regarding its Research and Planning program. Similarly, while the IRRRB agrees it will work to develop guidelines for direct loans, it should again be understood that, by definition, such guidelines need to be kept simple and flexible.

However, Bob Benner, Assistant Commissioner, will be responsible for addressing this area of concern and will work with senior agency staff to develop an action plan for direct lending prior to the September, 1994, IRRR Board meeting.

6. The IRRRB did not always adequately monitor delinquent bank participation loans.

The IRRRB maintains that, as a general practice, it has adequately monitored delinquent bank participation loans, with certain exceptions. Let us address each example cited.

First, it's important to re-emphasize that when the IRRRB enters into a bank participation loan, that it does so under the terms of a formal agreement through which it purchases up to fifty percent of a bank loan. This loan agreement specifies that the bank is clearly the lead lender with responsibility for monitoring and servicing the loan. While this does not relieve the IRRRB of its responsibility in monitoring bank participation loans, it does help explain why the agency sometimes is not immediately aware of every detail concerning problems or actions on a loan.

It's true that, in one instance, the IRRRB did not formally concur with the sale of assets of a delinquent borrower prior to the actual sale, although staff were well aware of the need and general plan to do so prior to the property going tax forfeit; at which time these assets would become essentially worthless.

The IRRRB does not dispute the audit findings regarding the timely contact of participating banks regarding delinquent loans in two specific instances; although it's important to note that staff review delinquency reports at least twice a month and generally contact the bank within 30 to 60 days of a loan first showing up as delinquent. However, our participation agreements allow the bank fifteen days to forward the IRRRB portion of the loan payment to the agency, and banking industry standards do not define a loan as delinquent until 30 days after the payment due date. Payment processing delays can occur between the bank and the agency and within the agency, and posting or other human errors must also be factored into the equation. All of which can potentially delay the agency contact of a bank regarding a specific delinquency.

Still, the IRRRB acknowledges that there's room for improvement in this area. Prior to the audit, the agency established geographical areas of responsibility for its business development activity. Part of the rationale behind this move was to allow for better monitoring and control of individual loans. Bob Benner, Assistant Commissioner, will be responsible for continuing agency efforts to improve its monitoring of delinquent loans and loans in general.

7. The IRRRB did not obtain board approval before allowing a foreclosed loan to be taken over by a third party.

Selling a bank participation loan to a third party does not constitute a new loan, and, thus, there's no need to go back to the IRRR Board to seek approval of such an action.

In addition, there are various considerations which make it impractical for the agency to bring proposed actions regarding a troubled loan in work-out status to the IRRR Board for their review prior to implementation.

However, the IRRRB agrees that it will discuss ways to inform the Technical Advisory Committee and IRRR Board of such actions after-the-fact. Exactly how this might be done requires careful consideration, as there are data-privacy and other concerns that must be addressed as a part of this discussion. In addition, prematurely publicizing a troubled loan may actually only exacerbate the situation and compromise the ability of the business to deal with minor short-term difficulties; or worse, to seek long-term solutions to major problems.

8. The IRRRB did not properly monitor certain aspects of its management service agreements with the Bowman Corporation.

In general, the IRRRB maintains that it *has* properly monitored the Bowman Corporation management agreements. The IRRRB strongly disagrees with that portion of the finding concerning the reimbursement of Bowman Corporation for mileage.

The IRRRB and Bowman Corporation clearly understood and agreed that in addition to the management fees paid to Bowman that the contractor would be reimbursed for expenses directly associated with the Olcott building management services. Accordingly, the IRRRB has reimbursed Bowman Corporation for mileage in accordance with the operating expenses section of the Olcott management agreement.

The basis for the IRRRB determination that the reimbursement of such expenses is appropriate under the terms of the management agreement is that these are expenses directly associated with Bowman's management of this facility, rather than indirect costs incurred by Bowman in the general conduct of their business as a management firm. Moreover, the IRRRB's interpretation of the agreement regarding this matter reflects customary business practice--that a contractor hired to provide such services to a client does so for a fee plus expenses.

Regarding the city water bills in arrears relating to Olcott Plaza, the IRRRB does not dispute that the bills were, in fact, in arrears. This occurred because of delays in processing the bills through both Bowman Corporation and the IRRRB. However, it's important to note that the IRRRB was aware that the water bills were in arrears, but understood that the city had no real problem with this situation, as it placed no hardship on the city.

Regarding the Bowman Corporation's certificates of insurance, Bowman Corporation has always maintained the insurance required by the management agreements. However, copies of the certificates of insurance were not available to the audit team during their visit. The IRRRB has now obtained copies of the required certificates of insurance from the Bowman Corporation for the Bowman contract file.

Regarding the review of the Coates Hotel operations, each month IRRRB staff reviews the Coates financial statements provided by an independent accounting firm. This information is then spread on a financial analysis spreadsheet, which reveals certain operating trends and ratios that are then discussed by phone with Bowman Corporation. It's true that the IRRRB has not actually done a detailed audit of selected transactions at the hotel to verify their propriety, although in its periodic visits to the hotel and its meetings and discussions with

Bowman Corporation, the IRRRB discovered nothing that suggests there's a critical need to do so.

9. The IRRRB improperly reimbursed a contractor for certain expenses.

The IRRRB has determined that it properly reimbursed the contractor in question for out-of-pocket expenses incurred in the delivery of services provided under the terms of the agreement. In fact, there is a well-documented paper trail which demonstrates that the IRRRB sought counsel from the Minnesota Departments of Employee Relations, Administration and Finance, as well as the Minnesota Office of the Attorney General, regarding the correct manner in which to handle these expenses. This ultimately *did* result in the contract being amended to further clarify that such expenses were allowable under the terms of the agreement.

That concludes our response to the audit findings. We wish to thank the Office of the Legislative Auditor for its continued assistance and cooperation.