

AGRICULTURAL UTILIZATION RESEARCH INSTITUTE
SELECTED SCOPE FINANCIAL AUDIT
FOR THE TWO YEARS ENDED SEPTEMBER 30, 1993

SEPTEMBER 1994

Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

94-44

SUMMARY

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

AGRICULTURAL UTILIZATION RESEARCH INSTITUTE

SELECTED SCOPE FINANCIAL AUDIT FOR THE TWO YEARS ENDED SEPTEMBER 30, 1993

Public Release Date: September 9, 1994

No. 94-44

AGENCY BACKGROUND

The Agricultural Utilization Research Institute(AURI) was established in 1989 as a non-profit corporation. It was formed to promote the establishment of new products and product uses and the expansion of existing markets for the state's agricultural commodities and products. AURI is governed by an 11 member board of directors. The board appoints an executive director to administer the institute. Richard Nelson has served as executive director since August 1991.

SELECTED AUDIT AREAS

♦ *Reserves and Investments*

AURI has maintained a significant fund balance since becoming an independent entity in 1989. It carries forward reserve balances from year to year. AURI's total fund balance at September 30, 1993 was \$4.2 million, a decrease from the September 30, 1992 total of \$5.7. AURI invests its fund balance and idle funds in various types of investments. The market value of investments at September 30, 1993 was \$6.1 million.

We found that AURI properly accounted for investment of reserve fund balances and related investment income. However, we believe controls over the investment process should be improved. AURI does not have a board approved investment policy or a formal agreement with its external investment manager, and it does not monitor investment performance and provide periodic reports to the board. In addition, AURI has not adequately separated the duties associated with investment activities.

♦ *Payments to Projects*

AURI provides technical expertise and financial assistance for new product research, development, and commercialization. The institute provides financial assistance through reimbursement of costs incurred on approved projects. AURI disbursed \$4.3 million in project payments during fiscal years 1992 and 1993. We found that AURI did not ensure that grantees submitted required quarterly reports before processing some contract payments.

♦ *Payroll*

AURI employee payroll and related benefits totaled \$1.6 million in fiscal year 1993. We found that AURI properly processed and adequately controlled payroll transactions.

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

Senator Phil Riveness, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Ms. Julie Bleyhl, Chair
Agricultural Utilization Research Institute Board of Directors

Members of the Agricultural Utilization Research Institute Board of Directors

Dr. Richard Nelson, Executive Director
Agricultural Utilization Research Institute

Audit Scope

We have completed a financial related audit of selected programs of the Agricultural Utilization Research Institute for the two years ended September 30, 1993. We emphasize that this has not been a complete audit of all programs of the Agricultural Utilization Research Institute, and that our audit was limited to only that portion of the financial operations 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 of the selected programs, and that we perform tests of the institute's compliance with certain material provisions of laws, regulations, contracts and grants. However, our objective was not to provide an opinion on the institute's internal control structure or on its 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:

- Reserves and investments;
- Payments to projects; and
- 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.

Senator Phil Riveness, Chair
Members of the Legislative Audit Commission
Ms. Julie Bleyhl, Chair
Members of the Agricultural Utilization Research Institute Board of Directors
Dr. Richard Nelson, Executive Director
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Management Responsibilities

Management of the Agricultural Utilization Research Institute 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 Agricultural Utilization Research Institute's accounting system in accordance with applicable 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

AURI properly accounts for the investment of reserve fund balances and related investment income. However, AURI does not have a board approved investment policy or a formal agreement with its external investment manager, and it does not monitor investment performance and provide periodic reports to the board. In addition, AURI has not adequately segregated the duties associated with investment activities. We discuss our conclusions on reserves and investments in Chapter 2.

AURI administers several financial assistance or grant projects. We found that AURI did not ensure that grantees submitted required quarterly reports before processing contract payments. We discuss our conclusions on payments to projects in Chapter 3.


Senator Phil Riveness, Chair
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Ms. Julie Bleyhl, Chair
Members of the Agricultural Utilization Research Institute Board of Directors
Dr. Richard Nelson, Executive Director
Page 3

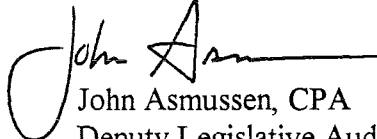
Payroll is AURI's largest administrative expense. As discussed in Chapter 4, AURI properly processed and adequately controlled its payroll transactions.

We also noted other matters involving the internal control structure and its operation that we reported to management of the Agricultural Utilization Research Institute at the exit conference held on August 23, 1994.

This report is intended for the information of the Legislative Audit Commission and management of the Agricultural Utilization Research Institute. This restriction is not intended to limit the distribution of this report, which was released as a public document on September 9, 1994.

We thank the Agricultural Utilization Research Institute staff for their cooperation during this audit.


James R. Nobles
Legislative Auditor


John Asmussen, CPA
Deputy Legislative Auditor

End of Fieldwork: June 17, 1994

Report Signed On: August 31, 1994

Agricultural Utilization Research Institute

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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
Patrick Ryan	Auditor-in-Charge
Geniene Herrlich	Auditor

Exit Conference

The findings and recommendations in this report were discussed with the following staff of the Agricultural Utilization Research Institute on August 23, 1994:

Julie Bleyhl	Chair, AURI Board
Dr. Richard Nelson	Executive Director
Mary Jo Crystal	Director of Finance and Human Resources

Chapter 1. Introduction

Laws of 1989, Chapter 350, Article 7, established the Agricultural Utilization Research Institute (AURI) as a nonprofit corporation. The institute was formed to promote the establishment of new products and product uses and the expansion of existing markets for the state's agricultural commodities and products.

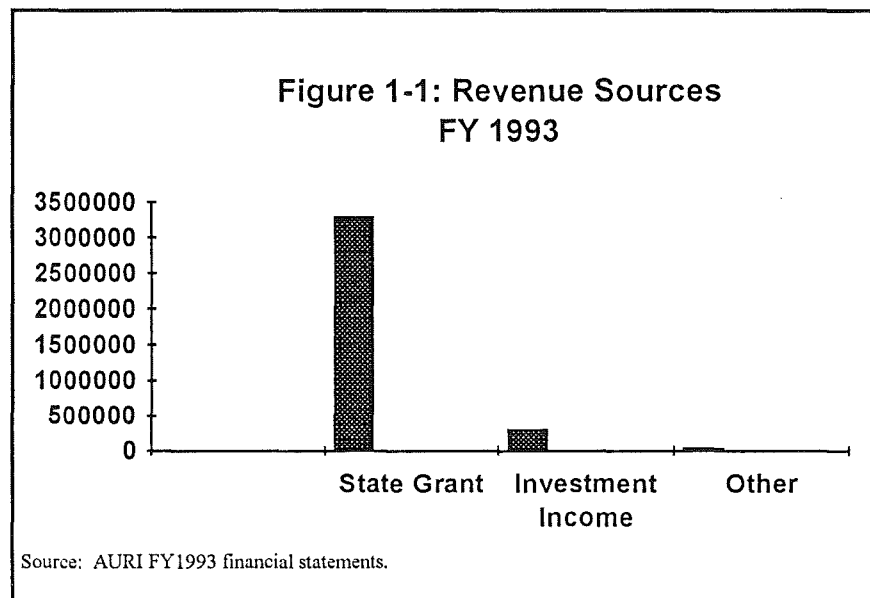
AURI is governed by an 11 member board of directors. Minn. Stat. Section 116O.09 establishes board membership, which includes two members of the Legislature and representatives of statewide farm organizations, agribusiness, and commodity promotion councils. The board is responsible for establishing agricultural utilization research priorities and awarding various grants and other financial assistance. The board of directors appoints an executive director to administer the institute. Richard Nelson has served as executive director since August 1991. The institute's main office is in Crookston on the University of Minnesota campus. There are four regional offices located in Crookston, Marshall, Morris, and Waseca, as well as a state office in St. Paul.

AURI's mission is to foster long-term economic benefit and increase business and employment opportunities to rural Minnesota through:

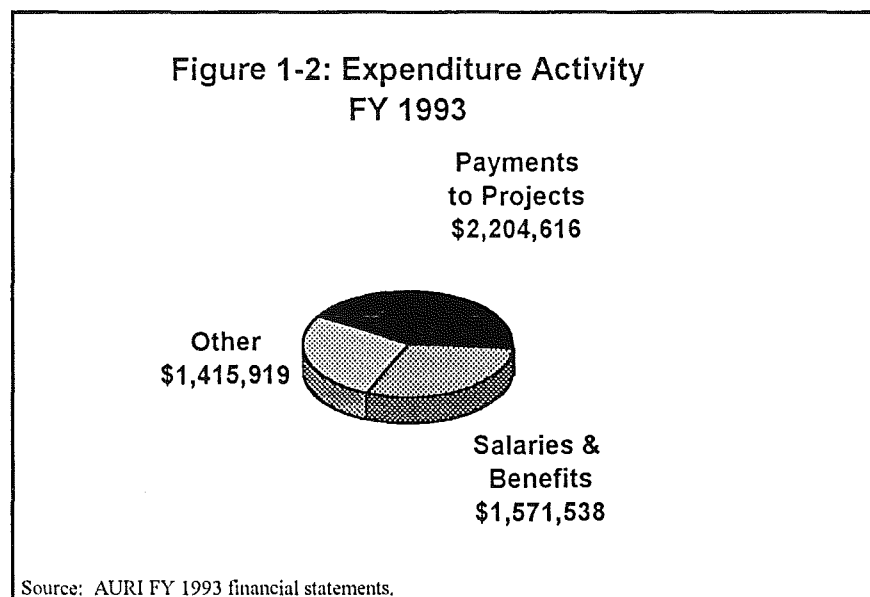
- identification and creation of new markets and expansion of existing markets for new or existing commodities, ingredients and products;
- development of more energy efficient, natural resource savings production practices; and
- development of new uses or value improvements for Minnesota agricultural commodities.

To accomplish this mission, AURI has designed programs to bring new products to the marketplace. These programs include Initial Product Assessment, Partnership, and Applied Research Technology Development. We describe these and other AURI programs in further detail in Chapter 3 of this report.

AURI has received funding primarily from the State of Minnesota. Prior to 1994, its appropriation passed through Minnesota Technology, Inc. in the form of grants. Beginning in state fiscal year 1994, the institute received funding from a direct General Fund appropriation. Fiscal year 1992 and 1993 revenues totaled \$5,567,091 and \$3,623,072, respectively. Revenues declined in fiscal year 1993 mainly because of a one-time \$1 million reduction in AURI's base state appropriation. Figure 1-1 shows the source of revenues for fiscal year 1993.



The institute had expenses of \$5.4 million in fiscal year 1992 and \$5.2 million in fiscal year 1993. AURI used approximately \$1.6 million of its accumulated reserves to close the gap between revenues and expenses in fiscal year 1993. Figure 1-2 summarizes the significant categories of expenses for fiscal year 1993.



Chapter 2. Reserves and Investments

Chapter Conclusions

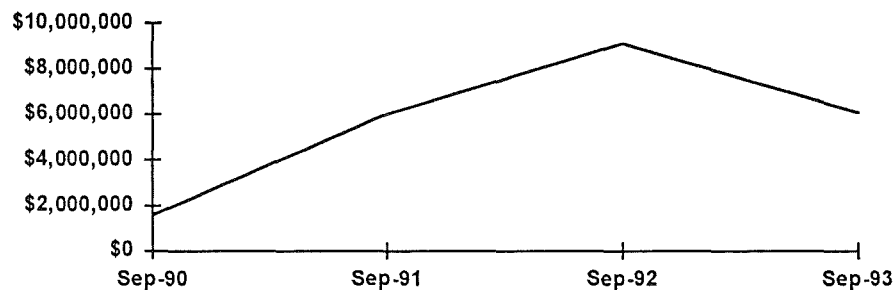
AURI properly accounted for investment of reserve fund balances and related investment income. However, AURI does not have a board approved investment policy or a formal agreement with its external investment manager, and does not monitor investment performance and provide periodic reports to the board. In addition, AURI has not adequately separated the duties associated with investment activities.

AURI has maintained a significant fund balance since becoming an independent entity in 1989. AURI staff directly invested idle funds until 1992 when the institute began using an external investment company to manage the portfolio. Prior to 1992, AURI invested primarily in certificates of deposit with various terms and interest rates. Many of the certificates exceeded the Federal Deposit Insurance Corporation's \$100,000 insured limit. AURI began phasing out certain certificates of deposit in early 1993. It has only invested in insured certificates since June 1993.

AURI carries forward reserve balances from year to year. At September 30, 1992, the institute's fund balance totaled \$5.7 million, of which \$4.3 million was unrestricted. At September 30, 1993, total fund balance decreased to \$4.2 million, of which \$2.9 was unrestricted. AURI develops an annual budget that the board of directors approves. In fiscal year 1993, AURI expended \$1.4 million less than the amount budgeted. The decreased expenditure level did not result in a significant increase in reserves, however, because AURI absorbed a one-time \$1 million cut in its fiscal year 1993 appropriation. AURI was \$1.9 million under budget for fiscal year 1994 through April 1994. Payments to projects was the most significant expenditure category under budget. These payments were \$946,000 less than budgeted for fiscal year 1993. Through April 1994 this category was \$1,244,000 under budget. AURI staff explained that it is difficult to budget this area due to the nature of the partnerships and the difficulty in predicting the number of applicants eligible for funding.

In addition to its reserve or fund balance, AURI has excess cash available for investment because of the timing of project payments. AURI commits funds, and establishes a liability, at the time projects are approved. However, portions of the project contracts will be paid out in future years. Figure 2.1 shows AURI cash and investment balances for fiscal years 1990 through 1993.

Figure 2.1
Cash & Investment Balances
FY 1990-93



Source: AURI FY 1990-1993 financial statements.

AURI invests reserve funds in many types of investments. AURI staggers investment maturities to provide available cash for operating needs. Investment income totaled \$581,048 in fiscal year 1992 and \$299,005 in fiscal year 1993. Table 2-1 summarizes the AURI investment portfolio at September 30, 1992, and 1993.

Table 2-1
Investment Portfolio
September 30, 1992 and 1993

<u>Investment Type</u>	<u>September 30, 1992 Fair Market Value</u>	<u>Percentage of Portfolio</u>
Mutual Funds	\$4,518,017	49%
Certificates of Deposit	3,577,948	38%
Cash	1,006,917	11%
FNMA Obligations	193,375	2%
Total	<u>\$9,296,257</u>	<u>100%</u>

<u>Investment Type</u>	<u>September 30, 1993 Fair Market Value</u>	<u>Percentage of Portfolio</u>
U.S. Treasury Securities	\$3,080,285	51%
Certificates of Deposit	2,430,250	40%
Money Market Accounts	253,817	4%
Cash	181,215	3%
Annuities	151,408	2%
Total	<u>\$6,096,975</u>	<u>100%</u>

Source: AURI FY 1992 and 1993 financial statements.

1. AURI does not have adequate controls over the investment account.

Our review of the investment of reserves found the following problems:

- AURI's Board of Directors has not adopted a comprehensive investment policy,

Agricultural Utilization Research Institute

- AURI does not have a formal agreement with the brokerage firm that manages its investment transactions,
- AURI staff do not monitor investment performance, and
- investment functions are not adequately segregated.

The AURI board of directors has not adopted a comprehensive investment policy. A policy should address investment scope and goals, types of authorized investments, risk tolerance, maturity limits, diversification, and relationships with banks and brokerage firms. Such a policy will aid AURI staff in properly investing the reserve balance in accordance with Board's intentions.

AURI does not have a formal agreement with the organization that manages its investment portfolio. An agreement would address the scope of work to be performed, types of authorized investments, and fee arrangements. There is an increased risk of mistakes or misunderstandings when an organization does not formalize the terms of financial agreements.

AURI does not monitor investment performance to determine if the invested funds are providing a rate of return consistent with the investment risk the board wants to adopt. Board members need periodic information on the status of investments to assist them in their decision making. AURI staff should prepare periodic investment performance reports and present them to the board for review and possible modification of investment philosophy.

AURI has not adequately separated the duties associated with investment activities. The same person is authorized to initiate investment transactions, approve cash withdrawals from the investment account, and reconcile the monthly account statements to the general ledger. To reduce the possibility of errors or irregularities going undetected, someone independent of authorizing transactions should perform the investment account reconciliation to the general ledger.

Recommendations

- *AURI's Board of Directors should adopt a comprehensive investment policy.*
- *AURI should formalize the terms and conditions governing the institutions which process investment transactions and manage the investment portfolio.*
- *AURI should monitor investment performance and provide the board with periodic reports.*
- *AURI should separate the duties of authorizing investment transactions and reconciling the investment account to the general ledger.*

Chapter 3. Payments to Projects

Chapter Conclusions

AURI disbursed \$4,280,00 in project payments during fiscal years 1992 and 1993. We found that AURI did not ensure that grantees submitted required quarterly reports before processing contract payments.

The Agricultural Utilization Research Institute provides technical expertise and financial assistance for new product research, development, and commercialization. The institute provides financial assistance through reimbursement of costs incurred on approved projects. In order to be reimbursed, project managers must provide supporting documentation for the payment. AURI project expenses totaled \$2,085,388 in fiscal year 1992 and \$2,194,583 in fiscal year 1993. We reviewed project expenses in six different program areas: Initial Product Assessment, Partnership Program, Applied Technology Development Program, New Markets Program, Applied Technology Consortium, and Commercialization Capacity. The following summarizes each of these programs.

- The Initial Product Assessment Program provides assistance for companies or universities interested in pursuing a potential Partnership Project or Applied Technology Development Project. AURI funds are not to exceed \$9,500 for each project.
- The Partnership Program seeks to establish partnerships in the form of long-term joint ventures with business for the purpose of developing and commercializing new agricultural product ideas, processes, and technologies that will expand the use of Minnesota agricultural commodities, new crops and animal products. Applicants may request Partnership funds in amounts up to \$100,000 for projects of one or two years in duration.
- The Applied Technology Development Program is intended to create new technologies and adapt existing technologies through applied research that will result in new uses for Minnesota agricultural commodities and potential commercialization. AURI will normally limit operating costs in any single Applied Technology Development Program project to \$100,000 per year for projects of one or two years in duration. However, grantees can exceed this limit if the technology appears very promising and still needs additional development.
- The New Markets Program is designed to assist farm organizations, commodity groups, grower associations and agribusiness groups to identify opportunities to develop new or alternative agricultural products.

Agricultural Utilization Research Institute

- The Applied Technology Consortium was designed as a separate program with the University of Minnesota to create new technologies and adapt existing technologies through applied research. AURI reserved \$1,487,194 for the university.
- The Commercialization Capacity is a program set up to analyze the use of and implementation of business incubators, which encourage the creation of new businesses in the local community. The total amount reserved for this project was \$623,000.

Table 3-1 provides a summary of expenses by program area.

Table 3-1
Payments To Projects
FY 1992 & 1993

<u>Project Type</u>	<u>FY 1992</u>	<u>FY 1993</u>
Partnership	\$ 786,787	\$1,362,460
Initial Product Assessment	508,177	379,457
New Market Projects	154,686	144,841
Applied Technology	374,312	253,123
Applied Technology Consortium	246,425	54,700
Commercialized Capacity	<u>15,000</u>	<u>0</u>
Total Expenses	<u>\$2,085,388</u>	<u>\$2,194,582</u>

Source: AURI FY 1992 and 1993 financial statements.

If the approved projects are successful, grantees must repay AURI funds. AURI negotiates repayment amounts based on various factors, such as anticipated royalties or profitability of the product, process, or service. The terms of repayment are date or event specific. Grantees repaid a total of \$1,754 in fiscal year 1993 and \$14,552 from July 1993 through April 1994. AURI has projected repayments to increase significantly as projects progress in the future.

We also tested discretionary expenses, which totaled \$34,285 in fiscal year 1993 and were budgeted at \$95,600 in fiscal year 1994. AURI authorizes regional managers and applied research personnel to provide funds to certain projects without following the formal grant process. The discretionary expenditure program allows flexibility in grants of small dollar amounts to projects. AURI procedures require secondary authorization of the discretionary expenses when the payment amount exceeds \$1,000.

2. Payments to projects are disbursed without required quarterly reports.

AURI does not ensure that grantees submit required project reports before it processes payments. Grantees for four of the ten projects tested had either not submitted reports or submitted them after established deadlines. In one case, a project was paid \$79,377 without submitting any quarterly reports. Project guidelines require that reports detailing progress to date and financial expenses attributable to the project be submitted to AURI on a quarterly basis. Contracts specifically state that "Any recipient who fails to submit their quarterly report within 30 days of

Agricultural Utilization Research Institute

the deadline will be placed on suspension until the report is received. Any expenditures incurred during the suspension period will be disallowed."

The monitoring of these reports is a key control to ensure that projects are proceeding properly and payments are for allowable project expenditures.

Recommendation

- *AURI should ensure that grantees submit required reports before it processes project payments.*

Chapter 4. Payroll

Chapter Conclusions

AURI properly processed and adequately controlled payroll transactions in fiscal years 1992 and 1993.

The institute has a staff of approximately 30 employees. Persons employed by the institute are not state employees but may participate in state retirement, deferred compensation, insurance, and other plans that apply to state employees. They are also subject to reporting requirements of the ethical practices board. The executive director is responsible for setting compensation and hiring and discharging employees within limits and policies established by the board.

AURI employee payroll and related benefits totaled \$1,536,858 in fiscal year 1992 and \$1,571,538 in fiscal year 1993. Employees submit biweekly time sheets to their supervisors. Supervisors review and approve the hours reported, and sign the time sheets of hourly employees. Administrative staff accumulate time sheets and enter hours worked. The information is electronically transferred to a private payroll processing firm. The firm processes the payroll data, and sends payroll checks to AURI for distribution to employees.

AURI established salary ranges for its various staff positions in 1990. Since then the board has authorized various combinations of cost of living and merit increases. Supervisors initiate salary increases through the performance review process. The board establishes parameters or ranges for employee increases. The executive director must authorize all individual increases. In fiscal year 1993, AURI did not provide across the board cost of living increases. Employees received merit increases based on performance. Salaried employees could receive a specific dollar amount, ranging from \$1,000 to \$2,900. Hourly employees could receive a percentage increase, up to 4.2 percent of base pay.

We reviewed AURI's payroll practices during fiscal years 1992 and 1993, and concluded that the board had established appropriate procedures and controls.

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Agricultural Utilization Research Institute

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26 August 1994

James R. Nobles, Legislative Auditor
Office of the Legislative Auditor
Centennial Building
St. Paul, MN 55155

Dear Mr. Nobles:

As requested by your office, please find enclosed the written response to the draft audit report of the Agriculture Utilization Research Institute for the two years ending September 30, 1993. The response reflects discussions at the exit conference held in your office on August 23, 1994, and attended by Ms. Gudvangen, Mr. Asmussen and Ms. Herrlich from your staff as well as Ms. Bleyhl (AURI Board Chair), Ms. Crystal (AURI Director of Operations) and myself.

Mr. Nobles, please let me take this opportunity to inform you of the thoroughly professional and pleasant conduct of all those on your staff who had a part in this audit. Your field team performed their duties in a timely and cooperative manner, and your office personnel provided all necessary information and assistance throughout the process. I am personally impressed by the effort made by your people to understand the nature of our business as well as the reasons for and function of our policies and procedures.

Thank you for providing a service that not only tests fiscal integrity on behalf of the Legislature, but also works to encourage cost-effective service delivery on behalf of the tax payer.

Richard R. Nelson
Executive Director
Agricultural Utilization Research Institute
Box 599
Crookston, MN 56716

c: C. Gudvangen
J. Bleyhl
M. Crystal

Legislative Audit of the Agricultural Utilization Research Institute

Response to the Draft Report of 29 July, 1994

Recommendations (p. 5)

♦ *AURI's Board of Directors should adopt a comprehensive investment policy*

Such a policy will be drafted by AURI staff (with grateful acknowledgment of offer by J. Asmussen to supply information regarding content) and presented to the AURI Board for consideration and approval on or before the end of the second quarter, FY '95.

♦ *AURI should formalize the terms [with] institutions [that] manage the investment portfolio*

Discussions shall be re-initiated. Previous efforts toward this end have not been satisfactorily concluded as a result of legal differences of opinion between the counsels of the respective parties.

♦ *AURI should monitor investment performance and provide the Board with periodic reports*

Such a report will be prepared and distributed to the Board on a regular basis. The Board may choose appropriate frequency of such reports.

♦ *AURI should separate the duties of authorizing ... and reconciling [transactions]*

AURI is a small organization with a strong commitment to keep administrative costs as low as possible. Within the past few months, the Institute's rapidly increasing project activity has justified a new position in the finance area. Training is now nearly complete, and the separation of duties as recommended will be in place by 1 October 1994.

Recommendation (p. 8)

♦ *AURI should ensure that grantees submit required reports before it processes project payments*

Please note that the vast majority of AURI projects carry a repayment obligation; they are not "grants". In addition, AURI processes payments on a reimbursement basis with adequate documentation of qualifying expenses required. Such documentation provides significant and timely information with regard to project progress and status. Nevertheless, AURI recognizes the important intent of this recommendation. Staff will review reporting requirements as well as the impact of such requirements on project performance. Current policy will be validated or modified as necessary, and steps will be taken to assure more uniform enforcement thereof.