



# Legacy Fund Recipients: Annual Report on Noncompliance

January 30, 2017  
REPORT 17-04

**Financial Audit Division**

**OFFICE OF THE LEGISLATIVE AUDITOR**  
STATE OF MINNESOTA

## Office of the Legislative Auditor Financial Audit Division

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The Financial Audit Division at the Office of the Legislative Auditor (OLA) performs three types of audits of entities within the state's executive and judicial branches:

- **Financial Statement** audits determine whether an entity has prepared its Comprehensive Annual Financial Report in accordance with governmental accounting principles. The division provides audit opinions on the financial reports for the State of Minnesota, the state's three large public pension plans, and the Minnesota Sports Facilities Authority.
- **Federal Grant Compliance** audits determine whether the state has complied with federal requirements for many of its largest federal programs. Often called the *Single Audit*, the federal government requires these audits as a condition of receiving federal grants.
- **Internal Controls and Legal Compliance** audits determine whether an entity has internal controls to effectively manage the risks of its financial operations and whether it has complied with legal compliance requirements chosen for testing.

The Financial Audit Division has a staff of about 35 auditors, many of whom are licensed CPAs and hold other certifications. The division conducts its audits in accordance with *Government Auditing Standards* established by the Comptroller General of the United States.

One requirement of the audit standards is a periodic review of the division's system of quality control by audit peers from across the country. The division's most recent peer review report is available at: [www.auditor.leg.state.mn.us/fad/pdf/fadpeer.pdf](http://www.auditor.leg.state.mn.us/fad/pdf/fadpeer.pdf)

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OLA also has a **Program Evaluation Division** that evaluates topics periodically selected by members of the Legislative Audit Commission.

In addition, OLA may conduct a **Special Review** in response to allegations and other concerns brought to the attention of the Legislative Auditor. The Legislative Auditor conducts a preliminary assessment in response to each request for a special review to determine what additional action, if any, OLA should take.



## OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA • James Nobles, Legislative Auditor

January 30, 2017

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Legislative Audit Commission

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Legacy Funding Finance Committee

Senator Carrie Ruud, Chair  
Environment and Natural Resources Policy and Legacy Finance Committee

This report responds to a requirement enacted by the Legislature in 2015. It requires the Office of the Legislative Auditor to issue an annual report that lists organizations that received money from Legacy funds and did not comply with applicable legal requirements. This is our first report issued in response to that law.

We hope you find this information useful.

Handwritten signature of James R. Nobles in black ink.

James R. Nobles  
Legislative Auditor

Handwritten signature of Cecile M. Ferkul in black ink.

Cecile M. Ferkul, CPA, CISA  
Deputy Legislative Auditor



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## INTRODUCTION

In November 2008, Minnesota voters approved the “Legacy Amendment.”<sup>1</sup> It raised the state’s sales tax 3/8 of 1 percent for 25 years and required the state to deposit the additional money into four separate funds and use the money only for the purposes stated in the Legacy Amendment.<sup>2</sup>

The Office of the Legislative Auditor (OLA) began auditing the state’s use of Legacy money in 2010.<sup>3</sup> We are issuing this report in response to a law passed in 2015. It requires OLA to issue an annual report listing organizations we found noncompliant with legal requirements related to their use of Legacy money.<sup>4</sup> We based this first report on the six audits we completed since the law went into effect, five of which had noncompliance findings.<sup>5</sup>

In addition to requiring an annual report, the 2015 law says that a recipient listed in the report “...is not eligible for future funding from...[the relevant Legacy fund] until the recipient demonstrates compliance to the legislative auditor.”<sup>6</sup>

The law clearly puts the burden on organizations to demonstrate compliance to OLA. However, to facilitate that process, we followed up several months ago with the organizations cited for noncompliance in three audit reports issued in 2015 and one issued in 2016. We reviewed the actions they have taken to resolve the noncompliance concerns we had raised, but we did not conduct a full re-audit of the issues.

Organizations listed in this report as still noncompliant may have taken additional actions since we made our follow-up inquiries. As these organizations come to the Legislature this year to request additional Legacy money, we will consider their testimony on the noncompliance issues. We will also welcome any additional information on the noncompliance issue they want to submit to OLA directly.

If a judgment about noncompliance noted in this report changes based on the testimony we hear or the information we receive, we will immediately inform the appropriate legislative committees and the organization affected. We will also note changes on our website.

Finally, we point out that some conclusions about compliance are difficult to make because the legal requirements are subject to varying interpretations. Those requirements involve: First, the requirement in the Legacy Amendment that says Legacy money must be used to “supplement not

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<sup>1</sup> *Minnesota Constitution*, art. XI, sec. 15.

<sup>2</sup> The constitutional amendment names the four funds Outdoor Heritage, Parks and Trails, Arts and Cultural Heritage, and Clean Water. For more information about the funds and the Legacy Amendment, see Office of the Legislative Auditor, Program Evaluation Division, *The Legacy Amendment* (St. Paul, 2011).

<sup>3</sup> Our reports are available at: [www.auditor.leg.state.mn.us/fad/fadsubj.htm#legacy](http://www.auditor.leg.state.mn.us/fad/fadsubj.htm#legacy).

<sup>4</sup> *Laws of Minnesota* 2015, First Special Session, chapter 2, art. 5, secs. 2-5.

<sup>5</sup> We issued a report that did not have any noncompliance findings on January 13, 2017. It involved the Department of Natural Resources’ use of money from the Outdoor Heritage Fund.

<sup>6</sup> *Laws of Minnesota* 2015, First Special Session, chapter 2, art. 5, secs. 2-5.

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substitute for” traditional sources of funding. Second, the statutory requirement that Legacy money only be used for administrative costs that are “directly related to and necessary for” the purposes of the specific appropriation. We discuss the issue of unclear legal requirements in a later section of this report.

## **NONCOMPLIANT RECIPIENTS OF LEGACY MONEY**

In the discussions that follow, we summarize the noncompliance concerns we raised in our original audit reports. An even briefer summary is in the appendix at the back of this report. For a complete discussion of the findings, please see the original reports. We cite the reports at the beginning of each discussion. See <http://www.auditor.leg.state.mn.us/fad/fadsubj.htm#legacy>.

### **Minnesota Historical Society: Arts and Cultural Heritage Fund**

*Office of the Legislative Auditor, Financial Audit Division, Minnesota Historical Society: Arts and Cultural Heritage Fund Expenditures, July 2012 through February 2015, report issued on September 1, 2015.*

We found that the society did not comply with *Minnesota Statutes* 2016, 16B.98, subd. 6, which states, “A granting agency shall diligently administer and monitor any grant it has entered into.” We believe this requirement means that any organization—including the Minnesota Historical Society—that grants Legacy money must establish internal controls to ensure that the money has been used consistent with the grant agreement and all other legal requirements.

We cited the society for advancing grant money without adequate internal controls. For example, the society did not review and approve final narrative and financial reports for two organizations that received Civics Education Grants appropriated from the Arts and Cultural Heritage Fund. Without this review and approval by the organization that granted the money, the state does not have assurance that the Legacy money was used for the authorized purposes.

In addition, we found that the society also did not comply with the requirement that all costs allocated to the fund must be “directly related to and necessary for” specific projects or activities listed in the appropriation law.<sup>7</sup> Instead, it allocated certain costs using arbitrary percentages multiplied against the salary costs it allocated directly to the projects and programs it supported with the money it received from the Arts and Cultural Heritage Fund.

In our 2016 follow-up review, we learned that the Minnesota Historical Society is no longer responsible for Civics Education Grants. Nevertheless, we still need the society to demonstrate that it has in place internal controls that will ensure that recipients of Legacy money will use it only for the purposes allowed in the relevant grant agreement, appropriation laws, statutory provisions, and constitutional requirements. In addition, we need assurance that the society has established a method of allocating costs that complies with all legal requirements.

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<sup>7</sup> *Laws of Minnesota* 2011, First Special Session, chapter 6, art. 4, sec. 2, subd. 2; and *Laws of Minnesota* 2013, chapter 137, art. 4, sec. 2, subd. 2.

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## Minnesota State Arts Board: Arts and Cultural Heritage Fund

*Office of the Legislative Auditor, Financial Audit Division, Minnesota State Arts Board: Arts and Cultural Heritage Fund Expenditures, July 2012 through February 2015, report issued on November 20, 2015.*

We found that the Minnesota State Arts Board did not comply with state grants management policies applicable to all executive branch agencies and established by *Minnesota Statutes* 2016, 16B.97. Specifically, the board had not documented its justification for advancing grant money to the regional arts councils,<sup>8</sup> had not conducted financial reconciliations of the money spent by the regional arts councils,<sup>9</sup> and did not review reports from the regional arts councils to see how grant money was used and what outcomes were achieved.<sup>10</sup>

In addition, the board did not comply with the constitutional requirement that Legacy money “must supplement traditional sources of funding...and may not be used as a substitute.”<sup>11</sup> We identified approximately \$225,000 of administrative expenses the board paid from Arts and Cultural Heritage Fund money that were previously paid with General Fund money and other funding sources. These costs included rent, information technology services, the executive director’s salary, and insurance. While we concluded that these costs met the “directly related to and necessary for” requirement, we questioned compliance with the “supplement not substitute for” requirement.

In our 2015 audit report on the Arts Board, we cited specific concerns about these two grant recipients:

- **Asian Media Access**

This nonprofit organization received a grant through the Minnesota State Arts Board. In its monitoring of the entity, the board identified costs that lacked adequate documentation or appeared to not comply with the purposes of the grant, including unapproved performances and out-of-state travel costs.

- **Pan Asian Alliance**

This entity received a grant through the Minnesota State Arts Board. In its monitoring of the entity, the board identified costs that lacked adequate documentation or appeared to not comply with the purposes of the grant, such as for excessive mileage, out-of-state gas receipts, vehicle rentals that did not match project dates, and other questionable costs.

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<sup>8</sup> See, Minnesota Department of Administration, Office of Grants Management Operating Policy and Procedure Number 08-08, *Policy on Grant Payments* (St. Paul, 2013).

<sup>9</sup> See, Minnesota Department of Administration, Office of Grants Management Operating Policy and Procedure Number 08-10, *Policy on Grant Monitoring* (St. Paul, 2011).

<sup>10</sup> See, Minnesota Department of Administration, Office of Grants Management Operating Policy and Procedure Number 08-09, *Policy on Grant Progress Reports* (St. Paul, 2008).

<sup>11</sup> *Minnesota Constitution*, art. XI, sec. 15.

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In our follow-up with the board in August 2016, we learned that the board was documenting its justification for advancing grant money to the regional arts councils. However, the board had not resolved the questionable use of Legacy money by Asian Media Access and Pan Asian Alliance.

## **Department of Administration: Arts and Cultural Heritage Fund**

*Office of the Legislative Auditor, Financial Audit Division, Department of Administration: Arts and Cultural Heritage Fund Expenditures, July 2012 through February 2015, report issued on November 20, 2015.*

The Department of Administration did not comply with *Minnesota Statutes* 2016, 16B.98, subd. 6, which states, “A granting agency shall diligently administer and monitor any grant it has entered into.” Its monitoring of grant recipients’ use of grant money was deficient because it did not comply with a state grants management policy applicable to all executive branch agencies and established by *Minnesota Statutes* 2016, 16B.97.

Specifically, the department had not conducted a financial reconciliation of the money spent by one of its grant recipients.<sup>12</sup> The department also did not adequately assess whether grant recipients’ costs complied with appropriation laws that required costs to be “directly related to and necessary for a specific appropriation.”<sup>13</sup> Finally, the department did adequately assess whether grant recipients’ costs complied with the constitutional requirement that Legacy money “must supplement traditional sources of funding...and may not be used as a substitute.”<sup>14</sup>

Our follow-up with the department in August 2016 showed that it had conducted the financial reconciliation of money spent by one of its grant recipients, but that it had not resolved the other issues cited in our report.

## **Metropolitan Council: Parks and Trails Fund**

*Office of the Legislative Auditor, Financial Audit Division, Parks and Trails Fund, July 2012 through February 2015, report issued February 11, 2016.*

The Metropolitan Council did not comply with *Minnesota Statutes* 2016, 16B.98, subd. 6, which states, “A granting agency shall diligently administer and monitor any grant it has entered into.”

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<sup>12</sup> See, Minnesota Department of Administration, Office of Grants Management Operating Policy and Procedure Number 08-10, *Policy on Grant Monitoring* (St. Paul, Revised August 31, 2011).

<sup>13</sup> *Laws of Minnesota* 2011, First Special Session, chapter 6, art. 4, sec. 2, subd. 2; and *Laws of Minnesota* 2013, chapter 137, art. 4, sec. 2, subd. 2.

<sup>14</sup> *Minnesota Constitution*, art. XI, sec. 15.

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The council had the following deficiencies in its administration and monitoring of grants from the Parks and Trails Fund to regional park implementing agencies:<sup>15</sup>

- The council did not obtain or review regional park implementing agencies' land appraisals or appraisal reviews.
- The council did not require regional park implementing agencies to submit documentation sufficient for council staff to determine whether expenses were allowable.
- The council did not assess the risks related to administering and monitoring these grants, and it had not documented its internal controls to address those risks.
- The council did not routinely visit regional park implementing agencies for the purpose of monitoring how the agencies administered the grants.

Our follow-up with the council in August 2016 showed that it had resolved the first and second deficiencies, but not the other two.

## **Department of Natural Resources: Parks and Trails Fund**

*Office of the Legislative Auditor, Financial Audit Division, Parks and Trails Fund, July 2012 through February 2015, report issued February 11, 2016.*

The department did not comply with appropriation laws that required costs to be “directly related to and necessary for a specific appropriation.”<sup>16</sup> In addition, the department did not comply with the constitutional requirement that Legacy money “must supplement traditional sources of funding . . . and may not be used as a substitute.”<sup>17</sup> The department could not show how some administrative costs it allocated to Parks and Trails Fund appropriations complied with these requirements.

Our follow-up with the department in August 2016 showed that it was waiting for further clarification about the requirements before changing its cost-allocation methodology.

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<sup>15</sup> The ten regional park implementing agencies include the counties of Anoka, Carver, Dakota, Ramsey, Scott, and Washington; the cities of Bloomington and St. Paul; the Minneapolis Park and Recreation Board; and the Three Rivers Park District, pursuant to *Minnesota Statutes* 2016, 473.351, subd. 1 (a).

<sup>16</sup> *Laws of Minnesota* 2011, First Special Session, chapter 6, art. 3, subd. 2; and *Laws of Minnesota* 2013, chapter 137, art. 3, subd. 2.

<sup>17</sup> *Minnesota Constitution*, art. XI, sec. 15.

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## Perpich Center for Arts Education: Arts and Cultural Heritage Fund

*Perpich Center for Arts Education: Internal Controls and Compliance Audit, July 2013 through March 2016, report issued on January 19, 2017.*

The Perpich Center for Arts Education did not comply with the requirement that all costs allocated to the fund must be “directly related to and necessary for” specific projects or activities listed in the appropriation law.<sup>18</sup> It charged the fund for some unrelated payroll, travel, and equipment costs, and made payment errors.

We have not made any follow-up inquiries given how recently we issued our report on the center.

## UNCLEAR LEGAL REQUIREMENTS

We have cited some organizations—in the reports noted above and in earlier reports—for not complying with two legal requirements that continue to be controversial. They are:

- The constitutional requirement says that Legacy money must be used to “supplement not substitute for” traditional sources of funding.
- The statutory requirement that Legacy money only be used for administrative costs that are “directly related to and necessary for” the purposes of the specific appropriation.

While the words in each requirement are relatively simple, they have been—and continue to be—subject to conflicting interpretations. Given this lack of agreement over their meaning, we decided in our last audit at the Minnesota Department of Natural Resources not to test the department for compliance with these two requirements. Instead, we are bringing the issue to the Legislature in this report and looking for clarification.

### Supplement Not Substitute

The Legacy Amendment says money from a Legacy fund must only be used to “supplement traditional sources of funding...and may not be used as a substitute.”<sup>19</sup>

We examined the history and meaning of this provision in a 2011 report.<sup>20</sup> We pointed out that legislators had different interpretations of the language when they were debating whether to put the Legacy Amendment on the ballot in 2008.

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<sup>18</sup> *Laws of Minnesota* 2013, chapter 137, art. 4, sec. 2, subd. 2; and *Laws of Minnesota* 2015, First Special Session, chapter 2, art. 4, sec. 2, subd. 2.

<sup>19</sup> *Minnesota Constitution*, art. XI, sec. 15.

<sup>20</sup> Office of the Legislative Auditor, Program Evaluation Division, *The Legacy Amendment* (St. Paul, 2011).

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In the 2011 report, we called the “supplement not substitute” language in the constitutional amendment confusing and perplexing, and labeled the uncertainty over its meaning an “Ongoing Concern.” We highlighted some of the questions the language had created. For example:

- When does a funding source become traditional? The constitutional amendment says that Legacy revenue should not be used to substitute for “traditional sources of funding.” The word traditional implies some level of historical consistency; yet, neither the constitution nor state law provides any guidance on exactly how many years of continuous funding would be required from a particular source for it to be considered traditional.
- Does frequency alone define traditional? For example, the Legislature may have used revenue from bond proceeds to fund certain projects for several years but without the intention of maintaining that approach for a more extended period of time. Nevertheless, based on history rather than intention, have bond proceeds now become a traditional source of funding for those types of projects?
- What happens when a traditional source is no longer available? The Legislature may have used federal funds to support certain programs and projects over several years, but they are no longer available from the federal government. To maintain those programs and projects, the Legislature might use Legacy revenues. Would that violate the Legacy amendment’s “supplement not substitute” provision?

Although these and other questions have remained unanswered, until recently we applied our understanding of what “supplement not substitute” means and cited organizations for noncompliance.<sup>21</sup> Before resuming our testing for compliance with this constitutional requirement, we ask the Legislature for clarification.

## Directly Related To And Necessary For

Legislators and groups that supported approval of the Legacy Amendment worked to limit the use of Legacy funds for administrative costs. Initially, the Legislature placed percentage caps on how much Legacy money could be spent on administrative costs. In 2011, the Legislature changed that approach in favor of requiring that Legacy money be used only for administrative costs that are “directly related to and necessary for” a legislatively authorized Legacy project or activity.<sup>22</sup>

Recipients of Legacy money have struggled with how to interpret and implement this language, particularly as it applies to those administrative costs that are often referred to as “overhead” or “indirect costs.” Because these are the costs that an organization incurs as part of its general

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<sup>21</sup> In our most recent Legacy audit, we did not test for the “supplement not substitute” requirement. See, Office of the Legislative Auditor, Financial Audit Division, *Department of Natural Resources: Outdoor Heritage Fund Expenditures*, July 2013 through February 2016, report issued on January 13, 2017.

<sup>22</sup> See, for example, *Laws of Minnesota 2011*, First Special Session, chapter 6, art. 4, sec. 2, subd. 2.

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operations, it can be difficult to show which of these costs are directly related to a project or activities connected to a specific appropriation of money from a Legacy fund. These costs include, for example:

- Facility costs, such as rent/lease, utilities, insurance, maintenance, and security.
- Management and staff support costs, such as executive management, legal services, human resources, accounting, financial reporting, information technology, general office equipment, and supplies.

In our 2011 report, we acknowledged that it might be difficult for organizations to show how administrative costs meet the “directly related to and necessary for” test.<sup>23</sup> On the other hand, we emphasized that agencies could not ignore this legal requirement. We expected the organizations we audited to demonstrate that they used Legacy money they received to pay only for costs that were “directly related to and necessary for” the programs and activities listed in the appropriation law, even though justifying the use of Legacy money on a detailed level would require staff time and involve costs.

OLA based its interpretation of this requirement on the understanding that it was intended to limit or restrict allowable uses of Legacy money. As a result, we assume there are some types of administrative costs that would not be allowable uses of Legacy money, even though those costs may typically be allowable administrative costs for another fund.

In September 2012, the Minnesota Department of Management and Budget (MMB) developed guidance for agencies about the “directly related to and necessary for” requirement.<sup>24</sup> These are some of MMB’s key points:

- The “direct and necessary” requirement is not unique to Legacy money, and efficient administration should be a goal with all state spending.
- The “directly related to and necessary for” requirement does not prohibit agencies from paying for the full cost of administering Legacy programs. Under law and state policy, all funds, including Legacy funds, should pay their portion of administrative costs and not be subsidized by the General Fund or other dedicated funding sources.
- Rather than requiring agencies and organizations to subsidize their Legacy funded programs with other funds, the “direct and necessary for” language requires that organizations adequately document and reasonably defend their Legacy fund expenditures.

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<sup>23</sup> Office of the Legislative Auditor, Program Evaluation Division, *The Legacy Amendment* (St. Paul, 2011).

<sup>24</sup> Minnesota Department of Management and Budget, *Guidance to Agencies on Legacy Fund Expenditure* (St. Paul, 2012).

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This guidance has resulted in agencies using cost allocation methods that do not adequately demonstrate a direct link between expenditures and Legacy projects. This approach conflicts with our interpretation of the “directly related to and necessary for” requirement. Yet, recent appropriation laws have suggested to agencies that if they follow MMB’s guidance they are complying with the “directly related to and necessary for” requirement. As a result, we are bringing the issue to the Legislature for clarification.

## **Conclusion**

The different interpretations of the “directly related to and necessary for” and the “supplement not substitute for” requirements have created unresolved disputes between OLA and the organizations that have received Legacy money. Until either the Legislature or the courts clarify the meaning of these two requirements, OLA lacks sufficient criteria to design effective tests to determine whether recipients of Legacy money are complying with the requirements.

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## Appendix: Summary of Findings of Noncompliance

State Agency	Fund	Report Date	Noncompliance	Resolution
Minnesota Historical Society	Arts and Cultural Heritage Fund	September 1, 2015	Did not comply with requirement to “diligently administer and monitor any grant it has entered into.” Did not comply with “directly related to and necessary for” requirement.	No longer responsible for specific grants cited in monitoring finding Need assurance related to “directly related to and necessary for” requirement.
Minnesota State Arts Board	Arts and Cultural Heritage Fund	November 20, 2015	Did not comply with state grants management policies, including justification for advancing grant money, conducting financial reconciliations, and reviewing final reports. Did not comply with “supplement not substitute” requirement. Specific grant recipients had expenditures that did not comply with the purposes of the grant.	Has documented justification for advancing grant money  “Supplement not substitute” compliance not resolved. Questionable uses of Legacy money by grant recipients not resolved.
Department of Administration	Arts and Cultural Heritage Fund	November 20, 2015	Did not comply with requirement to “diligently administer and monitor any grant it has entered into.”	Resolved some concerns related to financial reconciliation of money spent for one grant recipient. Outstanding concerns regarding whether grant recipients comply with “directly related to and necessary for” and “supplement not substitute” requirements remain.
Metropolitan Council	Parks and Trails Fund	February 11, 2016	Did not comply with requirement to “diligently administer and monitor any grant it has entered into.”	Resolved concerns related to land appraisals and expense documentation. Outstanding concerns related to internal controls and monitoring.
Department of Natural Resources	Parks and Trails Fund	February 11, 2016	Did not comply with “directly related to and necessary for” requirement. Did not comply with “supplement not substitute” requirement.	Unresolved; department waiting for clarification regarding these requirements.
Perpich Center for Arts Education	Arts and Cultural Heritage Fund	January 19, 2017	Did not comply with “directly related to and necessary for” requirement.	Unresolved.

SOURCE: Minnesota Office of the Legislative Auditor.



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