OLA

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

EVALUATION REPORT

State Grants to Nonprofit Organizations

JANUARY 2007

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OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA • James Nobles, Legislative Auditor

January 2007

Members of the Legislative Audit Commission:

In 2005, Minnesota state agencies made $4.7 billion in payments to nonprofit organizations. Approximately $1 billion was awarded in grants to almost 1,900 nonprofit organizations and administered by either a state or county agency. Reports issued by our office over the past few years have found problems with some Minnesota nonprofit organizations that received state funds. These investigations identified inappropriate spending of state funds by some grantees and highlighted inadequate oversight of state grants by several state agencies. In April 2006, the Legislative Audit Commission directed us to evaluate state grants to nonprofit organizations.

We found that the state has a fragmented and inconsistent approach to managing grants to nonprofit organizations, which does not provide adequate accountability. Furthermore, we found that agency oversight of grant recipients is especially weak when the Legislature selects and names a recipient in law, rather than allowing the agency to select the recipient. To improve administration and strengthen accountability of state grants, we recommend that the state establish a Grants Management Office in the executive branch with the expertise and authority to formalize and require agencies to follow the best practices discussed in this report. We also recommend that the Legislature not name grant recipients in law but allow agencies to select recipients through a competitive process.

This report was researched and written by Judy Randall (project manager) and Adrienne Howard. Staff in the departments of Education, Employment and Economic Development, Health, Human Services, Natural Resources, and Public Safety cooperated fully with our evaluation.

Sincerely,

James Nobles
Legislative Auditor

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- Agency oversight of grant recipients is especially weak when the Legislature selects and names a recipient in law, rather than allowing the agency to select the recipient (pp. 37-38).

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- The state should establish a Grants Management Office in the executive branch to strengthen accountability and improve management of state grants (p. 39).
- The Grants Management Office should have the authority to formalize and require agencies to follow the best practices discussed in this report (p. 41).
- The Legislature should not name grant recipients in law but allow agencies to select recipients through a competitive process (p. 42).

Report Summary

In 2005, the state awarded almost $1 billion in grants to approximately 1,900 nonprofit organizations.

Minnesota state government uses nonprofit organizations to provide a wide range of services to citizens and communities. Many of the services are provided by large nonprofit institutions (for example, hospitals and health plans). In addition, state agencies award individual grants to nonprofit organizations for services ranging from wetland protection to job training. In 2005, the state awarded almost $1 billion in grants to approximately 1,900 nonprofit organizations. The grants were administered by a state or county agency.

Currently, the state does not have a consistent approach for managing grants. The Department of Administration has developed guidelines and a model grant agreement to help state agencies, but it does not monitor how well agencies adhere to them. In lieu of a state grant management system, state agencies have developed their own grant policies. As a result, the state has a fragmented system of grant management and oversight. We found that actual grant management practices vary considerably and oftentimes provide inadequate oversight of state grants.

The report suggests some solutions to the state's inadequate management of grants. Specifically, we recommend that the state create a Grants Management Office in the executive branch to establish, implement, and enforce grant management best practices.

Nonprofit organizations have come under increased scrutiny.

Previous OLA investigations have found problems with some nonprofit organizations that receive state funds.

In recent years, there have been several reports nationally regarding the misuse of funds by nonprofit organizations. For example, the former chief of the Washington, D.C. chapter of the United Way pled guilty to stealing almost $500,000 of United Way funds, and the New York chapter of the United Way learned through an internal investigation that its former leader had diverted over $200,000 in charitable assets for personal use. These and other reports of misuse of funds by nonprofit organizations have been the focus of scrutiny by Congress.

In August 2006, Congress enacted legislation to reform the laws applying to nonprofit organizations. Included among the many reforms were provisions to (1) increase the penalties imposed on directors and officers who use their relationship with an organization for personal benefit, and (2) extend annual IRS reporting requirements to smaller nonprofit organizations.

Reports issued by our office over the past few years have also found problems with some Minnesota nonprofit organizations that received state funds. These investigations identified inadequate financial controls and inappropriate spending of state funds by some grantees. In addition, these reports highlighted inadequate oversight of state grants by several state agencies.

One-half of the state payments to nonprofit organizations in 2005 were for health- and education-related services.

Minnesota state government obtains goods and services from the private sector—both for-profit and nonprofit—in three basic ways: purchase orders, contracts, and grants. When state agencies use private sector organizations to obtain services for citizens or communities (not for state government itself), the payments are categorized as grants.

State payments to nonprofit organizations for all purposes, including grants and contracts, totaled $4.7 billion in 2005. For the purposes of this evaluation, we excluded nonprofit organizations that were more "institutional" in nature, such as health plans and hospitals. The services the state purchases from these organizations are closely regulated and payments are made directly through the state's centralized payment systems. The remaining nonprofit organizations are the focus of this report. In 2005, they received almost $1 billion through state grants administered by either a state or county agency.

Ten state agencies accounted for over 95 percent of the state funds paid to nonprofit organizations in 2005. The Department of Human Services alone accounted for almost two-thirds of the state funds paid to nonprofit organizations. Collectively, the departments of Human Services (DHS), Education (MDE), and Employment and Economic Development (DEED) accounted for almost 80 percent of expenditures made to nonprofit organizations in 2005. In contrast, 40 state agencies spent less than $10,000 in 2005 on services delivered by nonprofit organizations.

No single agency in the executive branch ensures that state grants are appropriately managed.

State funding to nonprofit organizations is heavily concentrated in a relatively small number of organizations. Of the 3,178 nonprofit organizations that received state funds in 2005, 229 (7 percent) received 75 percent of the state funding paid to nonprofit organizations.

In 2005, almost 60 percent of state funds awarded to nonprofit organizations was given to organizations providing services in one of the following three categories: (1) health services and related activities (30 percent of funds), (2) education and related services (19 percent), and (3) other activities directed to individuals (10 percent). A large number of cultural and business organizations also received state funds, although organizations in each of these categories received less than 1 percent of the state funds paid to all nonprofit organizations.

Minnesota state government has a fragmented approach to grant management that lacks oversight and accountability.

Unlike oversight of other state contracts, such as professional/technical and service contracts, Minnesota does not have a consistent approach to grant management. State statutes require the Department of Administration to approve most other contracts but allow the department to choose whether to approve grant contracts. Currently, the department does not approve other agencies' grant contracts or oversee them in any manner.

State statutes and the Department of Administration's contract policies provide some broad standards for grant management, but the policies are not enforced. One section in the Department of Administration's contract manual specifically addresses grants. While Administration staff told us these policies should be considered "directives" rather than suggestions, staff also acknowledged that they do not review agencies' practices to ensure that these policies are being implemented.

Despite having less consistent oversight, agencies manage significantly more funds through grants than through professional/technical contracts. As noted earlier, state agencies spent about $1 billion on grants to nonprofit organizations in 2005. Agencies also make grants to other entities, such as for-profit and government organizations, that are not included in this figure. In contrast, state agencies spent just over $354 million on all professional/technical contracts during the same time period.

In 2005, Governor Pawlenty's Drive to Excellence included a grants initiative that focused on the lack of a consistent statewide grant management process. The initiative found that: "There are no statewide standards in grants management policies, practices and supportive systems. This lack of consistency causes inefficiency in the administration of grants programs. . . ."[1]

Minnesota state agencies have their own grant management policies, which vary widely and provide for limited oversight and accountability.

We reviewed grant policies for six state agencies: MDE, DEED, DHS, and the departments of Health, Natural Resources (DNR), and Public Safety (DPS). These agencies ranged from having no agency-wide grant management policy (DNR) to detailed grant policies (MDE, DHS, and DPS).

None of the agencies we reviewed have grant policies that reflect all of the grant management evaluation criteria presented in the report. Most of the agencies that we reviewed do not have policies that require specific levels of monitoring, such as conducting formal site visits of grantees or reconciling requests for payment with financial documentation.

[1] State of Minnesota's Drive to Excellence, *Annual Report to the Governor* (St. Paul, December 2005), 41.

We reviewed 50 grants and found significant problems.

Minnesota state agencies provide inconsistent and sometimes inadequate oversight of grants.

To evaluate agency practices, we selected 50 grants made to nonprofit organizations. We selected a variety of nonprofit organizations for our review, including those that had received state funding for several years and those that were awarded new grants, those that received large payments from the state and some that received relatively small payments, and some that were specifically named in statute.

Our file review evaluated all phases of the grant management process—from grantee selection to grant closeout. In almost all of these phases, we found that state agencies differ in their management of grants. Moreover, we often found that units within state agencies differ in how they manage grants.

When we compared the grant management practices we observed through our file review to the evaluation criteria (best practices) outlined in the report, we found that the state's management of grants was often inadequate. For example, less than half of the grants we reviewed were competitively awarded. In only one-third of these grants, grant application reviewers were required to sign forms asserting that they did not have a conflict of interest. For less than one-quarter of the grants competitively awarded, grant applicants were required to submit financial information regarding the health of their organization.

For many of the grants we reviewed, agency staff did not verify that grant funds were used as intended.

Agencies varied widely in the level of monitoring they provided for their grants. In contrast to the evaluation criteria, agency staff conducted formal site visits in less than half of the grants we reviewed. Similarly, in 35 of the grants we reviewed, grant managers did not compare grant payment requests to grantees' financial records in order to verify that grantees used state grant funds as intended.

In general, state agencies provide less oversight of legislatively-mandated grant recipients than other grantee organizations.

The Legislature sometimes names or describes in law the organization that is to receive a state grant. Agency staff said that, because legislatively-mandated grantees are awarded funds by law, the agencies' enforcement authority over these grantees is unclear.

Ten of the grants we reviewed involved legislatively-mandated grantees. We found that agencies were in fact less likely to require work plans or interim reports and more likely to provide payments to these grantees in advance of work being performed. Grant managers were also less likely to conduct site visits for legislatively-mandated grantees than for grants to other organizations.

Introduction

Nonprofit organizations play an important role in Minnesota. Over 31,000 Minnesota nonprofit organizations provide a range of services, from social and environmental programs to education and dislocated worker services. In 2005, Minnesota state agencies paid almost $1 billion for services delivered by nonprofit organizations through state grants.

Nonprofit organizations have also been the subject of increased scrutiny, both in Minnesota and nationally. Stories about nonprofit organizations misusing funds are in the newspapers on a regular basis, and the federal government has recently tightened some of the rules regarding nonprofit organizations.[1] In addition, investigation reports issued by the Office of the Legislative Auditor (OLA) over the past few years have found problems with state agencies' oversight of grants to nonprofit organizations. These investigations identified inappropriate spending by some nonprofit organizations and inadequate oversight by several state agencies.[2] In 2002 our office released a special report on grants administration, which also identified several problems with agencies' oversight of state grants.[3]

In April 2006, the Legislative Audit Commission directed OLA to again evaluate state grants to nonprofit organizations, with a focus on how well the state administers these grants. We addressed the following questions:

- **To what extent does Minnesota state government use nonprofit organizations to deliver services? Which nonprofit organizations receive public funds, and what services do they perform?**

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[1] See, for example: Stephanie Strom, "United Way Says Ex-Leader Took Assets," *New York Times*, April 14, 2006, sec. B, p. 5; Walter V. Robinson and Michael Rezendes, "Foundation Chief Agrees to Repay Over $4 Million," *Boston Globe*, December 16, 2004, sec. A, p. 1; Tom Vanden Brook, "Red Cross to Release Results of Fraud Inquiry; 3 Volunteers Have Been Dismissed," *USA Today*, March 27, 2006, sec. A, p. 3; and Pension Protection Act of 2006, Pub. L. No. 109-280, §§1212, 1223, and 1224.

[2] See, for example: Office of the Legislative Auditor, *Special Review: State and City Contracts with the Minnesota Council on Compulsive Gambling* (St. Paul, June 2005); Office of the Legislative Auditor, *Minnesota Department of Education and Metropolitan Educational Cooperative Service Unit Administration of Grant Funds* (St. Paul, October 2004); and Office of the Legislative Auditor, *Administration of State Funds by the African American Mentor Program, Inc.* (St. Paul, July 2004).

[3] Minnesota Office of the Legislative Auditor, *Minnesota Grants Administration* (St. Paul, January 2002).

- **To what extent does Minnesota have consistent and effective grant management policies? How do state policies compare with those of other grant makers?**

- **How well does the state oversee grants to nonprofit organizations?**

To address these questions, we relied on several sources of information. We obtained data from the Internal Revenue Service, the Minnesota Department of Revenue, the Department of Employment and Economic Development, and the Attorney General's Office to identify all of the nonprofit organizations in the state and obtain descriptive information on them. To determine the extent to which Minnesota state government uses nonprofit organizations to provide services, we accessed payment data from the Minnesota Accounting and Procurement System (MAPS). Using this data, we were able to identify which nonprofit organizations received state funding.

We reviewed the Minnesota statutes and rules that govern grant and contract administration and spoke with staff in eight state agencies (the departments of Administration, Education, Employment and Economic Development, Finance, Health, Human Services, Natural Resources, and Public Safety). We reviewed the national literature and spoke with staff from other states and Minnesota foundations to learn how other institutions manage their grants. We also spoke with staff involved with Minnesota's Drive to Excellence grant management initiative.

Finally, to better understand how state agencies actually manage their grants, we reviewed 50 grant contracts across six state agencies. In addition, we met with the agency staff most responsible for these grants to learn more about grant management practices.

This report is divided into three chapters. Chapter 1 provides an overview of nonprofit organizations in Minnesota, outlines their legal requirements, and compares them with for-profit corporations. In Chapter 2, we discuss the extent to which Minnesota uses nonprofit organizations to deliver services. Specifically, we outline how much state agencies pay nonprofit organizations and what services are provided by these organizations. Chapter 3 reviews state and agency policies for grant management and presents the findings from our file review. Chapter 3 also contains recommendations for the Legislature and state agencies. The appendix at the back of the report lists the nonprofit organizations that received the 50 grants included in our review.

1

Background

SUMMARY

There are over 31,000 nonprofit organizations in Minnesota that provide a range of services. These organizations are regulated by federal and state laws that outline which services they can provide and how they must be governed. Recently, several nonprofit organizations have been criticized for misusing their funds, and the nonprofit sector as a whole has come under increased scrutiny.

Nonprofit organizations in Minnesota comprise a significant part of the state's economy, employing almost 10 percent of the workforce in 2005. When considering nonprofit organizations, most people think of charitable organizations. However, nonprofit organizations encompass a broader group of organizations including veterans' organizations, fraternal organizations, credit unions, and sports and hunting clubs, among many others.

In this chapter, we provide a general overview of nonprofit organizations in the state. We address the following questions:

- **What are nonprofit organizations and how do they differ from for-profit organizations?**
- **How many nonprofit organizations are in Minnesota and what types of services do they provide?**

To answer these questions, we reviewed Minnesota and federal statutes, federal regulations, Internal Revenue Service (IRS) publications, previous Office of the Legislative Auditor reports, and the national literature related to nonprofit organizations. We also analyzed data from the IRS, Minnesota Department of Revenue, Minnesota Department of Employment and Economic Development (DEED), and the Minnesota Attorney General's Office to obtain descriptive information about nonprofit organizations in the state.

OVERVIEW OF NONPROFIT ORGANIZATIONS

While nonprofit organizations can compensate their officers and employees, by law they cannot earn profits for their members.[1] This characteristic distinguishes nonprofit organizations from for-profit companies, and their private status distinguishes them from governments and other public entities. Below, we outline the broad legal requirements for nonprofit organizations and compare these requirements to those pertaining to for-profit companies.

[1] *Minnesota Statutes* 2006, 317A.011, subd. 6.

Legal Requirements

In general, nonprofit organizations are structured in one of four ways—as a trust, association, cooperative, or corporation. Minnesota law establishes requirements for each of these organizational structures. Charitable trusts, the most common type of nonprofit trust, are an estate-planning tool used to dedicate funds to charitable purposes.[2] Associations are nonprofit organizations that are not incorporated and are governed by common law rather than statute. Cooperatives are groups of persons and organizations that form around specific interests to provide services to their members. Most nonprofit organizations are structured as corporations. To be a corporation, nonprofit organizations must register their name and file articles of incorporation with the Secretary of State; they must also be managed by a board of at least three directors. In addition, nonprofit corporations must, at a minimum, have one or more officers who serve as president and treasurer. The law also establishes provisions for the operation of the board, such as procedures for meetings and voting, and requirements for members' meetings and voting procedures. These provisions apply unless formally modified by the organization. A nonprofit corporation may choose whether to have members and whether to develop bylaws.[3]

Minnesota laws require directors of nonprofit corporations to meet certain standards of conduct.

Minnesota statutes require directors of nonprofit corporations to meet a minimum standard of conduct, including the responsibility to act in a manner consistent with the best interests of the organization.[4] The attorney general may bring an action against directors of nonprofit organizations for breach of their duty if this standard of conduct is not met.[5] Specifically, the law requires directors to actively participate in the management of the organization by attending meetings, evaluating the work of committees, becoming familiar with the organization's books and records, and ensuring the organization complies with federal and state legal requirements, among other things. The law also limits transactions between a nonprofit corporation and a director that pose a conflict of interest, and prohibits directors from diverting, for their personal gain, a business opportunity that would have been suitable for the nonprofit corporation.[6]

Nonprofit organizations can qualify for exemption from federal and state income taxes.[7] Federal law specifies a broad range of categories of nonprofit organizations that qualify for tax exemption, including labor unions, chambers of commerce, veterans' organizations, and charitable organizations.[8] Most organizations must apply with the IRS to receive the exemption; however, places

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[2] *Minnesota Statutes* 2006, 501B.31-501B.45.

[3] *Minnesota Statutes* 2006, chapter 317A.

[4] *Minnesota Statutes* 2006, 317A.251, subd. 1.

[5] *Minnesota Statutes* 2006, 8.31.

[6] *Minnesota Statutes* 2006, 317A.255; and Minnesota Office of the Attorney General, "Fiduciary Duties of Directors of Charitable Organizations," http://www.ag.state.mn.us/charities/charDuties.html; accessed May 2, 2006.

[7] 26 *U.S. Code* §501 (2005). Minnesota nonprofit organizations that are exempt from federal corporate income tax are also exempt from state corporate income tax. See *Minnesota Statutes* 2006, 290.05. Some Minnesota nonprofit organizations are also exempt from local property tax. See *Minnesota Statutes* 2006, 272.02.

[8] 26 *U.S. Code* §501 (2005).

of worship and certain types of organizations with annual incomes that do not exceed $5,000 are automatically exempt.[9] Nonprofit organizations must also comply with annual federal and state reporting requirements. Although they do not file income tax forms, most nonprofit organizations are required to file annual financial information with the IRS.[10] Minnesota law also requires most charitable organizations that solicit contributions within the state to register with and submit annual information reports to the Minnesota Attorney General's Office.[11]

The most common type of nonprofit organization, called a "501(c)(3) organization," is limited by federal law to specific purposes, such as charitable, educational, and religious.

The most commonly known tax-exempt nonprofit organizations are the 501(c)(3) organizations. Specific federal requirements govern the operation of these organizations. For example, 501(c)(3) organizations must limit their activities to the following purposes: religious, charitable, scientific, testing for public safety, literary, educational, fostering national or international amateur sports competition, or preventing cruelty to children or animals.[12] In addition, these organizations are prohibited from participating in the political campaign of any candidate for public office and are limited in their lobbying activities.[13] State and local governments can create 501(c)(3) organizations such as state schools or hospitals, provided they are not an integral part of the government and do not possess governmental powers.[14]

Nonprofit and For-Profit Corporations

As illustrated in Table 1.1, nonprofit corporations and for-profit corporations differ in several ways. As noted earlier, while nonprofit corporations cannot earn profits for their members, the primary purpose of for-profit corporations is to earn profits for their shareholders. While for-profit corporations are accountable to their shareholders, nonprofit corporations are accountable to their donors and

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[9] 26 *C.F.R.* §1.508-1(a)(3) (2005).

[10] Certain organizations, such as places of worship, are exempt from the annual IRS reporting requirement. Although previously exempt, recent legislation added a limited annual reporting requirement for exempt organizations with gross annual receipts that normally do not exceed $25,000. See Internal Revenue Service, *Tax-Exempt Status for Your Organization,* Publication 557 (Washington, D.C., March 2005), 8-9; and Pension Protection Act of 2006, Pub. L. No. 109-280, §1223.

[11] Certain organizations are exempt from this filing requirement such as places of worship that do not file an annual federal information return, societies that limit solicitation of contributions to voting members, and organizations with no paid staff that do not receive or plan to receive more than $25,000 in total contributions from inside or outside Minnesota in one year. See *Minnesota Statutes* 2006, 309.50, subd. 4; 309.515.

[12] The organization's articles of incorporation must limit its purpose to these purposes and must not permit it to engage in other activities. Internal Revenue Service, *Tax-Exempt Status*, 19.

[13] 26 *U.S. Code* §501(c)(3) (2005); and Internal Revenue Service, *Tax-Exempt Status*, 17, 45-46. Organizations are subject to a tax if they exceed limits on lobbying activities.

[14] In previous reports, our office has criticized agencies when they have created nonprofit organizations without specific legislative authority. For example, see Office of the Legislative Auditor, *Department of Corrections Special Review: MINNCOR Industries and Minnesota Correctional Education Foundation* (St. Paul, July 2006), 13.

Table 1.1: Comparison of Requirements for Nonprofit and For-Profit Corporations

	Nonprofit Corporations	For-Profit Corporations
General Requirements		
Earn profits for shareholders	No	Yes
Pay federal and state income tax	No	Yes
Individuals to whom the organization is accountable	Donors, clients, and members	Shareholders
Annual IRS income tax filing requirement	Federal financial information return (Form 990)	Federal corporate income tax return
Governance Structure Requirements		
Required to file annually with the Secretary of State	Yes	Yes
Managed by a board of directors	Yes (minimum of three directors)	Yes (minimum of one director)
Default provisions require annual board meetings	Yes	No
Default voting provisions for board[a]	A quorum is a majority (but cannot be less than one-third); action requires the majority vote of those present	Same, but no minimum requirement for the quorum
Committees	Board may establish committees by a vote of the majority	Same
Required officers	President and treasurer	Same, but positions named chief executive officer and chief financial officer
Director and officer standard of conduct	Must discharge duties in the best interests of the corporation	Same
Director conflict of interest provision	Prohibits certain transactions between directors and corporation	Same
Default provisions require annual member or shareholder meetings	Yes	No
Default voting provisions for members or shareholders[a]	A quorum is 10 percent of voting members; action requires the vote of a majority of those present	A quorum is the majority of the shares entitled to vote; action requires a majority of the shares voted.
Record retention and inspection	Must retain items such as articles of incorporation, bylaws, accounting records, and meeting minutes for six years	Must retain same items and additional items such as share information for three years

NOTE: Some of the statutory provisions are mandatory, while others are default provisions that the corporation may alter in its articles of incorporation or, in some cases, its bylaws.

[a] A quorum is the number of individuals required to be present at a meeting for an organization to take official action; statutes set different standards for a quorum. Statutes also establish the number or percentage of affirmative votes required for the board to pass a measure. The provisions discussed above are default provisions that generally apply, but the statutes establish different quorum and vote requirements for specific types of board or shareholder/member actions.

SOURCE: *Minnesota Statutes* 2006, chapters 317A and 302A.

the clients or members they serve.[15] Finally, in contrast to nonprofit corporations, for-profit corporations are subject to state and federal corporate income tax.

Despite these differences, nonprofit and for-profit corporations share a similar governance structure, as shown in Table 1.1. Both types of organizations must be managed by a board of directors and both are required to file annually with the Secretary of State. Both types of organizations must have a person in the role of president and treasurer (named chief executive officer and chief financial officer in for-profit organizations), and directors and officers are held to a similar standard of conduct for both types of corporations. In addition, state law establishes similar meeting and voting requirements for the board of directors of both types of organizations.[16]

NONPROFIT ORGANIZATIONS IN MINNESOTA

In 2005, nonprofit organizations employed almost 10 percent of the Minnesota workforce.

Minnesota nonprofit organizations comprise a significant part of the state's economy. Nonprofit organizations employed over 262,000 employees in 2005, accounting for almost 10 percent of the Minnesota workforce in that year. This segment of the economy is also large in terms of its revenue. In tax year 2004, Minnesota nonprofit organizations reported income of $51.8 billion.[17] We found that, as of April 2005:

- **There are over 31,000 nonprofit organizations in Minnesota providing a wide range of services.**

Through IRS data listing tax-exempt organizations in Minnesota, we identified over 31,000 nonprofit organizations. However, this is likely a conservative estimate of the number of nonprofit organizations with activities in the state. For example, some tax-exempt organizations are not required to file with the IRS, such as places of worship and most 501(c)(3) organizations with annual gross income that does not exceed $5,000. We obtained additional data on nonprofit organizations from the Minnesota Attorney General's Office, DEED, and the Minnesota Department of Revenue for a recent three-year period and found over 36,000 nonprofit organizations that had some contact with the state.

Nonprofit organizations in Minnesota provide a wide range of services, from medical services and recreational activities to services for veterans offered through VFW and American Legion posts. Table 1.2 describes the IRS tax-exempt categories of nonprofit organizations and, for each category, shows the number of nonprofit organizations in Minnesota.

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[15] Shareholders of for-profit corporations and members of nonprofit corporations, if they exist, hold corporations accountable through their right to hold meetings and to elect directors. Nonprofit corporations may also be accountable to donors because some organizations rely on donors for funding. Some nonprofit organizations that provide services to clients may compete with other organizations for clients.

[16] *Minnesota Statutes* 2006, chapters 302A and 317A.

[17] Tax year 2004 data cover a two-year period because organizations can operate on a calendar year or a variety of fiscal years. Of the 31,167 Minnesota nonprofit organizations in the IRS database, there were 11,368 for which tax year 2004 data were available. Some organizations are not required to report annual income information to the IRS, some organizations were new in 2005, and others had only more recent tax year 2005 data available.

Table 1.2: Minnesota Nonprofit Organizations by Tax-Exempt Category

	Description of Category	Number of Nonprofit Organizations	Percentage of Nonprofit Organizations
501(c)(3) organizations	Organizations with one of the following purposes: religious, charitable, scientific, testing for public safety, literary, educational, fostering national or international amateur sports competition, or preventing cruelty to children or animals	20,277	65.1%
Social welfare organizations	Organizations operated to promote social welfare, such as volunteer firefighter organizations	2,878	9.2
Business leagues	Organizations such as chambers of commerce and trade associations	1,853	5.9
Labor, agricultural, or horticultural organizations	Labor unions and agricultural organizations	1,537	4.9
Veterans' organizations	Organizations such as VFW and American Foreign Legion posts that provide services to veterans	1,375	4.4
Fraternal beneficiary societies	Societies operated under the lodge system that provide for the payment of life, sickness, accident, or other benefits to members[a]	1,281	4.1
Social clubs	Organizations created for recreational purposes supported solely by membership fees, such as country clubs, hunting clubs, and hobby clubs	666	2.1
Domestic fraternal societies	Societies operated under the lodge system that devote their net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes[a]	430	1.4
Cemetery companies	Organizations for burial and related activities	242	0.8
Voluntary employee beneficiary associations	Organizations that provide for payment of life, sickness, accident, or other benefits to members	231	0.7
Other[b]	Credit unions, title-holding corporations, and others	397	1.3
Total organizations		31,167	

[a] The lodge system is a form of organization that comprises a parent organization and mostly self-governing local branches called lodges or chapters.

[b] Other less common tax-exempt categories include credit unions, title-holding corporations, mutual insurance companies, state-sponsored high risk insurance organizations, and state-sponsored workers' compensation insurance organizations.

SOURCES: Office of the Legislative Auditor's analysis of data in Internal Revenue Service, *Exempt Organization Information Available Through the Statistics of Income (SOI) Tax Stats Web Site,* http://www.irs.gov/taxstats/charitablestats/article/0,,id=97186,00.html; accessed April 19, 2006; and Internal Revenue Service, *Tax-Exempt Status for Your Organization*, Publication 557 (Washington, D.C., March 2005).

The majority (65 percent) of nonprofit organizations in the state are 501(c)(3) organizations. Organizations within the 501(c)(3) category provide many different types of services in Minnesota. For example, 62 percent of these organizations are charitable organizations, such as branches of the United Way, hospitals, health maintenance organizations, homeless shelters, and environmental organizations; 21 percent are educational organizations, such as private schools, parent-teacher associations, school booster clubs, and scholarship programs. About 15 percent of the 501(c)(3) organizations in the state are religious organizations, and the remaining 2 percent are literary organizations, scientific organizations, organizations working to prevent cruelty to animals or children, and organizations for public safety testing.

While the majority of nonprofit organizations in Minnesota are 501(c)(3) organizations, there is a wide variety of other types of nonprofit organizations in the state. Table 1.2 illustrates the breadth of categories of nonprofit organizations in Minnesota. For example, over 9 percent of the state's nonprofit organizations are social welfare organizations such as Kiwanis and Rotary clubs, volunteer firefighter organizations, and the League of Women Voters. Almost 5 percent of the state's nonprofit organizations are labor, agricultural, or horticultural organizations such as the American Federation of State, County, and Municipal Employees (AFSCME), county farm bureau associations, and the Minnesota Livestock Breeders Association. A wide variety of social clubs comprise 2 percent of the nonprofit organizations in Minnesota, including the Hibbing curling club, the Wayzata yacht club, and the Faribault rifle and pistol club. Fraternal beneficiary societies (fraternal societies that provide benefits to members) include Thrivent Financial for Lutherans and the Knights of Columbus, while the Masons and the Fraternal Order of the Eagles are examples of domestic fraternal societies.

Nonprofit organizations receive income from many different sources, including charitable contributions, government grants, membership dues and fees, investment income, and program service revenue. Program service revenue is revenue earned by a nonprofit organization when it provides the services that form the basis of its tax-exempt status. For example, payments received by a nonprofit hospital for providing medical services and tuition paid to a nonprofit school are treated as program service revenue. Program service revenue also includes Medicare or Medicaid payments. We obtained data regarding the sources of income for 8,001 charitable organizations soliciting contributions in Minnesota that were registered with the Minnesota Attorney General. The two largest components of income for these organizations were charitable contributions and program service revenue. These organizations received a total of $24.6 billion in contributions in tax year 2004, $3.6 billion of which were government grants. They received an additional $21.5 billion in program service revenue in that year.[18]

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[18] The data on the type of income received by nonprofit organizations was available for charitable organizations registered with the Minnesota Attorney General's Office but not for all tax-exempt organizations in the IRS database. As a result, the total reported income of $51.8 billion for tax-exempt organizations in tax year 2004 will not equal the sum of the categories of income discussed here.

Although the nonprofit sector as a whole is large, most nonprofit organizations are small in size; most operate on a volunteer basis or have only members, such as fraternities and social clubs. In 2005, only about 3,400 nonprofit organizations in Minnesota had employees. Because many nonprofit organizations have multiple locations in the state, these nonprofit employers had over 4,600 locations in the state. Figure 1.1 shows the number of nonprofit employer locations in each of 13 state regions.[19] About half of nonprofit employers are located in the Twin Cities metropolitan area, reflecting the large population of this area. For the most part, locations are evenly distributed among the other regions of the state. However, the Southeast (including Rochester) and the Northeast (including Duluth) have somewhat more nonprofit employers, while regions 2 (North Central) and 6W (Southwest) have the lowest number of nonprofit employers.

While most Minnesota nonprofit organizations have few employees and small incomes, some—such as hospitals and health plans—are quite large.

Even nonprofit organizations with employees tend to be small. Among the approximately 3,400 nonprofit employers, over half (56 percent) had less than 10 employees in 2005. Similarly, over 40 percent of nonprofit organizations with employees paid less than $100,000 in total wages in 2005. Organizations are also small in terms of the amount of income they receive. For all nonprofit organizations in the state (not just those with employees), over 40 percent earned income less than $100,000 in tax year 2004.

Some Minnesota nonprofit organizations, however, are quite large in size. In 2005, about 12 percent of Minnesota nonprofit employers had 100 or more employees. Similarly, almost 14 percent of nonprofit organizations with employees paid over $2 million in total wages in 2005. Some Minnesota nonprofit organizations also receive significant incomes. In tax year 2004, 6 percent of all Minnesota nonprofit organizations received more than $5 million in total income. Most of the large nonprofit organizations in the state are those in the health care industry, such as hospitals, medical clinics, nursing homes, and health maintenance organizations.

MISCONDUCT BY NONPROFIT ORGANIZATIONS

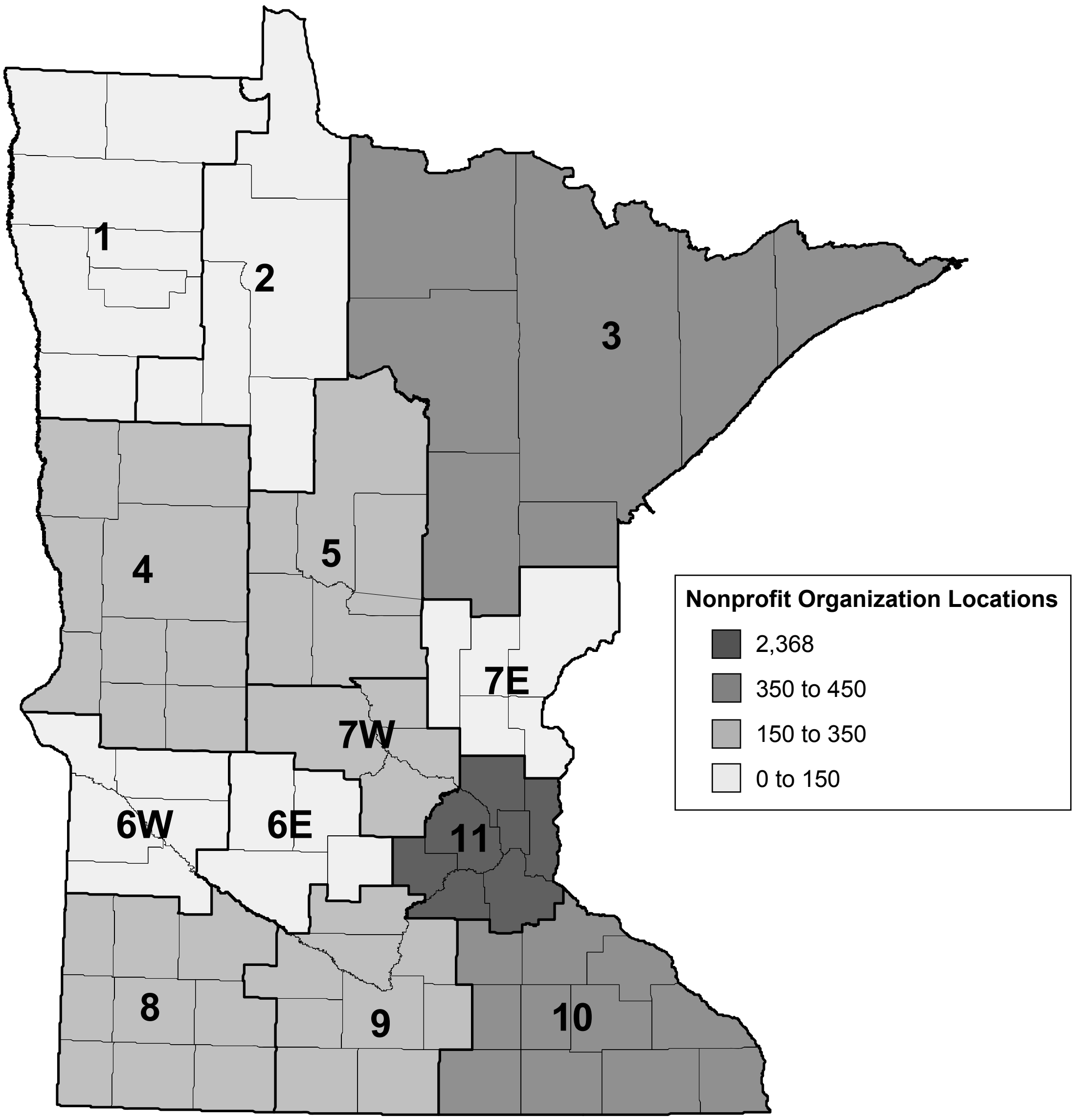
In recent years, reports of misuse of funds by nonprofit organizations have received national attention. For example, the former chief of the Washington, D.C. chapter of the United Way pled guilty in 2004 to stealing almost $500,000 of United Way funds.[20] In April 2006, the New York chapter of the United Way learned through an internal investigation that its former leader had diverted over $200,000 in charitable assets for personal use.[21] The Boston Globe published a

[19] We analyzed the location of nonprofit employers using DEED's 13 economic development regions.

[20] Carrie Johnson, "Charities Going Beyond Required Controls to Regain Their Donors' Confidence," *The Washington Post*, April 6, 2005, sec. E, p. 1.

[21] Stephanie Strom, "United Way Says Ex-Leader Took Assets," *New York Times*, April 14, 2006, sec. B, p. 5.

Figure 1.1: Locations of Minnesota Nonprofit Employers, 2005



NOTES: Nonprofit organizations without paid employees are not included in this figure. There are an additional 100 nonprofit employers with "statewide" locations that are also not included in this map.

SOURCE: Office of the Legislative Auditor's analysis of data from the Department of Employment and Economic Development.

series of reports on leaders of foundations spending foundation funds for extravagant personal expenditures.[22] In addition, the American Red Cross has been criticized for mismanagement and for misconduct by volunteers following the Hurricane Katrina disaster.[23]

These and other reports of misuse of funds by nonprofit organizations have been the focus of scrutiny by Congress. Senator Charles Grassley, chairman of the United States Senate Finance committee, has led investigations and held hearings regarding allegations of abuse by nonprofit organizations, including the American Red Cross, The Nature Conservancy, and the credit counseling organization industry.[24] In August 2006, Congress enacted legislation to increase incentives for charitable giving and to reform the laws regulating nonprofit organizations. Included in the legislation were provisions to (1) increase the penalties imposed on directors and officers who use their relationship with an organization for personal benefit, (2) permit the IRS to disclose to state officials overseeing nonprofit organizations information about IRS investigations of nonprofit organizations, and (3) extend annual IRS reporting requirements to organizations with gross annual receipts that do not exceed $25,000.[25]

In recent years, OLA investigations have found inappropriate spending of state funds by several Minnesota nonprofit organizations.

Over the past few years, OLA has investigated similar misconduct of some Minnesota nonprofit organizations that received state funds.[26] These investigations identified inappropriate spending of state funds and inadequate financial controls. In addition, these reports highlighted inadequate oversight by several state agencies of state grants to nonprofit organizations. In recent years, our office has conducted investigations of the Minnesota Council on Compulsive Gambling, Metropolitan Educational Cooperative Service Unit, and African American Mentor Program, Inc., among others.

In 2002, our office released a special report on grant administration that identified several problems with agencies' oversight of state grants, including grants to nonprofit organizations. The report said state agencies did not adequately monitor grant recipients to ensure that funds were used as intended. In response to that report and OLA investigations of nonprofit organizations, some state agencies have made changes to their grant administration policies. However, these changes have been limited and are specific to individual agencies or grant programs.

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[22] Walter V. Robinson and Michael Rezendes, "Foundation Chief Agrees to Repay Over $4 Million," *Boston Globe*, December 16, 2004, sec. A, p. 1; and Minnesota Office of the Attorney General, *Giving Makes a Difference: Minnesota Attorney General Charities Profile, 2005*, http://www.ag.state.mn.us/charities/GivingMakesADifference.html; accessed October 24, 2006.

[23] Tom Vanden Brook, "Red Cross to Release Results of Fraud Inquiry; 3 Volunteers Have Been Dismissed," *USA Today*, March 27, 2006, sec. A, p. 3; and The Associated Press, "Red Cross Plans Changes in Disaster Relief; Agency Tells Senators It Will Crack Down on Waste, Partner with Other Aid Groups," *St. Louis Post-Dispatch*, April 4, 2006, sec. A, p. 6.

[24] Joe Stephens, "Charity's Land Deals to Be Scrutinized; Senators to Send Letter to Nature Conservancy," *The Washington Post*, May 10, 2003, sec. A, p. 2; The Associated Press, "Red Cross Plans Changes in Disaster Relief; Agency Tells Senators It Will Crack Down on Waste, Partner with Other Aid Groups," *St. Louis Post-Dispatch*, April 4, 2006, sec. A, p. 6; and Jacqueline Salmon and Kirstin Downey, "IRS Ruling Imperils 'Gift Fund' Charities for Home Buyers," *The Washington Post*, June 2, 2006, sec. A, p. 1.

[25] Pension Protection Act of 2006, Pub. L. No. 109-280, §§1212, 1223, and 1224.

[26] OLA conducted these investigations in response to allegations that specific nonprofit organizations were misusing state funds. The office does not routinely audit nonprofit organizations.

2

The State's Use of Nonprofit Organizations

SUMMARY

Minnesota state government relies on nonprofit organizations to provide a wide range of services. In 2005, Minnesota state government awarded approximately $1 billion in grants to almost 1,900 nonprofit organizations. Nonprofit organizations provide an array of services on behalf of the state, ranging from environmental services to employment training for the disabled.

Minnesota state government uses nonprofit organizations to deliver services for a variety of reasons. Nonprofit organizations are often seen as an efficient way to provide a service because the state does not have to hire more employees or build facilities. In addition, by using community-based nonprofit organizations, the state is able to leverage organizations that may already be working with targeted populations.

In this chapter, we address the following questions:

- **To what extent does Minnesota state government use nonprofit organizations to deliver services?**

- **Which entities receive public funds, and what services do they perform?**

To determine the extent to which the state uses nonprofit organizations to provide services, we identified Minnesota nonprofit organizations using data from the Internal Revenue Service (IRS), the Attorney General's Office, the Department of Employment and Economic Development (DEED), and the Minnesota Department of Revenue. Using the Minnesota Accounting and Procurement System (MAPS), we determined the extent to which these organizations received funding from state agencies. We also evaluated descriptive data from the IRS, DEED, and the Attorney General's Office regarding nonprofit organizations that received state agency funds. In addition, we obtained information from human services agencies in seven counties (Hennepin, Pennington, Redwood, Scott, St. Louis, Waseca, and Washington) to evaluate the extent to which counties use nonprofit organizations to provide services.

PAYMENTS TO NONPROFIT ORGANIZATIONS

State payments to nonprofit organizations totaled over $4.7 billion in 2005. Generally, state government obtains goods and services from nonprofit organizations in the same way it obtains them from for-profit organizations—through purchase orders, contracts, and grants. Using purchase orders and

State agencies use grants to obtain services or products for citizens or communities.

contracts, state agencies buy goods and services for their own use. Because of their relevance to this evaluation, the requirements agencies must follow in using professional/technical and service contracts are discussed in Chapter 3.[1]

When state agencies use a private sector organization—typically a nonprofit—to obtain services or products for citizens or communities, they provide money to the organization through grants.[2] For example, the Minnesota State Arts Board awards grants to local theater organizations to produce shows, and the Department of Human Services (DHS) provides grants to nonprofit organizations to assist certain people with transportation services. Grants can be for one-time projects or on-going services. Technically, payments to hospitals, health care plans, and other institutions for services provided to citizens and other third parties are categorized by the state's accounting system as grants. However, for the purposes of this evaluation, we excluded these "institutional" organizations because their services are closely regulated by the state and they are not commonly considered grant recipients.[3] After excluding them, we found that the state paid $1.05 billion to 3,178 nonprofit organizations in 2005.

Excluding "institutional organizations," such as hospitals and health plans, the state paid $1.05 billion to nonprofit organizations in 2005.

As shown in Table 2.1, ten state agencies accounted for over 95 percent of the state funds paid to nonprofit organizations in 2005. The Department of Human Services alone accounted for almost two-thirds of the state funds paid directly to nonprofit organizations. Of this amount, 66 percent were payments to nonprofit organizations providing medical assistance services. Collectively, DHS, DEED, and the Department of Education (MDE) accounted for almost 80 percent of the state expenditures made to nonprofit organizations in 2005. In contrast, 40 state agencies spent less than $10,000 in 2005 on services delivered by nonprofit organizations.

State funding to nonprofit organizations is heavily concentrated in a relatively small number of organizations. Of the 3,178 nonprofit organizations that received state funds in 2005, 229 (7 percent) received 75 percent of the state funding paid to nonprofit organizations. Table 2.2 shows the ten nonprofit organizations that received the most state funds in 2005. Collectively, these ten organizations received almost $142 million (over 13 percent) of the state funds paid to nonprofit organizations in 2005. The nonprofit organization that received

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[1] Professional/technical contracts are contracts for services that are "intellectual in character" and result in the production of a report or the completion of a task. See *Minnesota Statutes* 2006, 16C.08, subd. 1. Service contracts are contracts for any "nonprofessional or technical service," such as snow plowing, copy machine repair, and housekeeping. See Department of Administration, *State Contracting* (St. Paul, 2001), sec. 1, 1; and *Minnesota Statutes* 2006, 16C.02, subd. 16.

[2] As defined by the Department of Administration, "grants are financial assistance paid or services furnished by a state agency via a third party to an eligible recipient. . . . The state is not actually getting anything with a grant, it is paying for someone else to get something." See Department of Administration, *State Contracting*, sec. 24, 1.

[3] Specifically, we excluded the following types of nonprofit organizations that received state funding: health plans, hospitals, health care systems, medical groups, and dental clinics; nursing homes, assisted living facilities, and hospice organizations; emergency medical services, ambulance services, and volunteer firefighter organizations; the Minneapolis, St. Paul, and Duluth teachers' pension funds; libraries and library consortiums; schools (public, private, charter, school district cooperatives, and higher education institutions); and the Minnesota Historical Society. Grant payments made to schools do not include school aid funding. Although we excluded hospitals in general, we did include those that were identified as "essential community providers" by the Minnesota Department of Health. If we include all nonprofit organizations, the state paid 3,826 nonprofit organizations in 2005.

the most state funding in 2005, Lifeworks Services, Inc., received over $21.5 million. In contrast, the average nonprofit organization received approximately $329,000 from the state in 2005, while the median organization received almost $11,000.[4]

Even after payments to hospitals and health plans are excluded, the Department of Human Services accounted for almost two-thirds of the state's payments to nonprofit organizations in 2005.

Table 2.1: Ten State Agencies with the Highest Payments to Nonprofit Organizations, 2005

	Amount (in millions)	Percentage
Department of Human Services	$697	66.2%
Department of Education	82	7.8
Department of Employment and Economic Development	56	5.3
Housing Finance Agency	40	3.8
Department of Commerce	33	3.2
Department of Public Safety	33	3.1
Department of Health	20	1.9
Department of Transportation	14	1.4
Department of Natural Resources	14	1.4
Minnesota Supreme Court	11	1.0
Total Top Ten Agencies	$1,000	95.1%
Total All Agencies	$1,052	100.0%

NOTES: These payments include state and federal funds provided by state agencies to nonprofit organizations for all purposes. Department of Human Services expenditures include payments to nonprofit organizations providing medical assistance services. This analysis excludes payments made to most hospitals, health care systems, health plans, medical groups, hospice organizations, nursing homes, assisted living facilities, schools, libraries, ambulance services, volunteer firefighter organizations, and the Minnesota Historical Society.

SOURCE: Office of the Legislative Auditor.

Nonprofit organizations that received funding from the state in 2005 were, by a variety of measures, larger than other nonprofit organizations in Minnesota. They were more likely to have (1) more employees, (2) more assets, and (3) more income than other nonprofit organizations in the state. Table 2.3 illustrates the difference in size between nonprofit organizations that received state funding in 2005 and those that did not. Nonprofit organizations that received state funds had a median of 16 employees in 2005, compared with 3 for nonprofit organizations that did not receive state funds. Similarly, based on tax year 2004 data, nonprofit organizations that received state funds had a median income of about $523,000, compared with $99,000, and had median assets of $512,000, compared with $131,000 for other nonprofit organizations.

[4] The median represents the middle amount the state paid to nonprofit organizations in 2005. One-half of the nonprofit organizations that received state funding in 2005 received less than the median, and one-half received more.

Table 2.2: Ten Nonprofit Organizations that Received the Most State Funding, 2005

Organization	Amount (in millions)	Type of Service Provided
Lifeworks Services, Inc.	$21.5	Serves developmentally disabled adults during the day
Providers Choice, Inc.	21.0	Sponsors licensed family daycare home providers
Mankato Rehabilitation Center, Inc.	16.1	Provides vocational rehabilitation, habilitation, and therapeutic services to people with disabilities
Prairie Community Services, Inc	15.5	Operates group homes for the mentally retarded and mentally ill
Dakota Communities, Inc.	15.4	Assists individuals in the greater metropolitan area who have disabilities
Community Involvement Programs, Inc.	12.4	Provides residential and training programs for developmentally disabled and mentally ill adults
Hammer Residences, Inc.	10.4	Provides residential and support services to people with developmental disabilities
Duluth Regional Care Center, Inc.	10.1	Provides residential services to mentally disabled adults
Partners in Community Supports, Inc.	9.9	Provides programs to provide support for persons with disabilities
Homeward Bound, Inc.	9.3	Provides residential care to developmentally disabled individuals
Total Top Ten Recipients	$141.7	
Total All Nonprofit Organizations	$1,052.3	

NOTES: These payments include state and federal funds provided by state agencies to nonprofit organizations for all purposes. This analysis excludes most hospitals, health care systems, health plans, medical groups, hospice organizations, nursing homes, assisted living facilities, schools, libraries, ambulance services, volunteer firefighter organizations, and the Minnesota Historical Society.

SOURCES: Office of the Legislative Auditor; and Minnesota Attorney General's Office, Charities Division, "Charities Search;" http://www.ag.state.mn.us/charities/Char_Srch.asp; accessed May 26, 2006.

Examining more closely the $1.05 billion that was paid to 3,178 nonprofit organizations in 2005, we found that $999 million was awarded in grants to 1,883 nonprofit organizations.[5] About $300 million of this amount was awarded through what could be called a "traditional" grant and administered through a state agency. The remaining grants—amounting to approximately $699 million—were paid through state payment systems, where they received some level of state agency oversight, but they were generally administered through county human services agencies. These types of grants include payments to nonprofit organizations for medical assistance services and services for the developmentally disabled.[6]

[5] Over 56 percent of the funding for these grants came from state funds, while the remainder came from federal funds.

[6] Many of these payments were for Medicaid "waiver" programs. See Office of the Legislative Auditor, *Medicaid Home and Community-Based Waiver Services for Persons With Mental Retardation or Related Conditions* (St. Paul, February 2004) for more information on these types of programs.

Table 2.3: Nonprofit Organizations that Received State Agency Funds Compared with Those that Did Not, 2005

	Nonprofit Organizations that Received State Funding	Nonprofit Organizations that Did Not Receive State Funding
Median Number of Employees	16	3
Median Income	$522,741	$98,953
Median Assets	$512,384	$131,076

NOTES: This analysis excludes most hospitals, health care systems, health plans, medical groups, hospice organizations, nursing homes, assisted living facilities, schools, libraries, ambulance services, volunteer firefighter organizations, and the Minnesota Historical Society. Income and asset figures are for tax year 2004.

SOURCE: Office of the Legislative Auditor.

County governments also use nonprofit organizations to deliver services.

In addition to Minnesota state government, county governments also use nonprofit organizations to deliver services. We obtained human services expenditure information from seven counties (Hennepin, Pennington, Redwood, Scott, St. Louis, Waseca, and Washington) and identified how much they paid for services provided by nonprofit organizations in 2005.[7] The county expenditure data represent payments to nonprofit organizations that are not included in the state's payment systems. We focused on county human services expenditures because, in Minnesota state government, DHS is the largest purchaser of services from nonprofit organizations. Combined, these seven counties paid approximately 1,850 nonprofit organizations over $106 million to provide human services. Hennepin County accounted for over $87.7 million of these payments, while Redwood County paid nonprofit organizations just under $1 million. Counties varied in their reliance on nonprofit organizations to provide services. Payments from these seven counties to nonprofit organizations ranged from about 12 percent (Scott County) to about one-third of the county's human services expenditures (Waseca County).

SERVICES PROVIDED BY NONPROFIT ORGANIZATIONS

Minnesota state government does not have detailed information on state grants, such as the purpose of each grant or its recipients. As a result, it is difficult to determine which services the state relies on nonprofit organizations to provide. However, when nonprofit organizations file for tax-exempt status with the IRS, they provide codes describing the types of activities in which they generally engage. We used these codes to determine, in a general way, the types of services provided by nonprofit organizations that received state funds. We found that:

[7] Most of these counties did not have complete information to determine whether vendors were nonprofit organizations. As a result, we used a variety of sources to identify counties' nonprofit vendors. The figures provided are an estimate of county human services payments to nonprofit organizations.

- **Minnesota state government pays nonprofit organizations to provide a broad array of services, ranging from rehabilitation and employment services for the disabled to environmental and conservation services.**

Most commonly, the state uses nonprofit organizations to provide health or education-related services to citizens and communities.

Table 2.4 shows the range of activities conducted by nonprofit organizations that received state funds in 2005. The table shows that nonprofit organizations that received state funds were most likely to engage in (1) education-related activities, (2) health services and related activities, and (3) business and professional activities. There is a wide range of services within each of these categories of activities. Table 2.4 lists some examples of the types of services within each category generally provided by nonprofit organizations that received state funds. For example, education-related activities include job and employment training services for the disabled, nonprofit radio and television stations, child care centers, and Head Start program providers, among many others. Health services and related activities include medical clinics, rehabilitation and support services for the disabled, and a variety of other health-related services such as Meals on Wheels.

We also examined which categories of service received the largest amount of state funds. Table 2.5 shows the percentage of state funds provided to nonprofit organizations based on the type of services they provide. As discussed above, the majority of state funds provided to nonprofit organizations are concentrated in a small number of organizations. Similarly, almost 60 percent of state funds are spent on organizations providing services in one of the following three categories: (1) organizations providing health services and related activities (30 percent of funds), (2) organizations providing education and related services (19 percent of funds), and (3) organizations providing other activities directed to individuals (10 percent).[8] This allocation of funds is expected because, as noted earlier, DHS, DEED, and MDE are responsible for about 80 percent of the payments to nonprofit organizations, and they would likely purchase these types of services. While a large number of business and cultural organizations received state funds in 2005, these types of organizations received relatively small amounts of funds. Each of these categories received less than 1 percent of state funds paid to nonprofit organizations.

The activities of nonprofit organizations that received state funds in 2005 differed from those that did not receive state funds. When compared with other nonprofit organizations, those that received state funds were more likely to engage in (1) health services and related activities, and (2) other activities directed to individuals. On the other hand, nonprofit organizations that received state funds were less likely than other nonprofit organizations to engage in (1) religious activities; (2) employee or membership benefit association activities; and (3) sports, athletic, recreational, and social activities. The difference in activities between nonprofit organizations that received state funds and those that did not makes sense given the general business of state government. The state tends to fund health services and other support services for citizens rather than churches and social clubs.

[8] This category includes (1) providing funds or services to the poor, (2) gifts or grants to individuals other than scholarships, (3) job training or counseling, (4) social agency referral services, (5) drug and alcohol treatment, (6) day care centers, (7) services for the elderly, (8) marriage counseling, (9) family planning, and (10) credit counseling assistance.

Table 2.4: Activities Conducted by Nonprofit Organizations that Received State Funds, 2005

	Percentage of Organizations Engaged in Activity	Examples of Services and Organizations
Education-related activities	19.3%	Training for the disabled, radio and television stations, child care, Head Start program providers
Health services and related activities	14.4	Medical clinics, rehabilitation and support services for the disabled, Meals on Wheels
Business and professional activities	11.9	Chambers of commerce, local convention and visitor bureaus, trade associations
Cultural, historic, artistic, or other similar education-related activities	9.5	Theatres, museums, orchestras, art centers, county historical societies
Other activities directed to individuals[a]	9.2	Services to the poor, job training, drug and alcohol treatment
Other instruction or training activities	8.8	Information and referral services, discussion groups, publishing activities, training
Inner city or community activities	8.7	Community action councils, economic development organizations, crime prevention
Activities of employee or membership benefit associations	8.0	Employee associations, employee credit unions, cooperative electricity organizations
Youth activities and juvenile delinquency	6.5	YMCA, Boys and Girls clubs, youth camps, child abuse prevention
Housing activities	5.4	Low-income housing and housing for the elderly
Religious activities	5.2	Churches and associations of churches
Aid to charitable organizations	4.0	United Way and foundations
Sports and social activities	4.0	Various sports clubs and social clubs
Conservation, environmental, and beautification activities	3.1	Preservation of natural resources and wildlife habitat conservation
Scientific research	3.0	Medical and other types of scientific research
Other[b]	12.0	Fraternities, credit unions, veterans' organizations
Missing	21.6	

NOTES: Of the 3,178 nonprofit organizations that received state agency funds in 2005, 2,877 were in the IRS database. Of these organizations, 2,257 had IRS activity code information. Activity codes describe the work of the organization generally rather than the specific services they provide to the state. Nonprofit organizations can have up to three activity codes. This analysis excludes hospitals, health care systems, health plans, medical groups, hospice organizations, nursing homes, assisted living facilities, schools, libraries, ambulance services, volunteer firefighter organizations, and the Minnesota Historical Society.

[a] This category includes (1) providing funds or services to the poor, (2) gifts or grants to individuals other than scholarships, (3) job training or counseling, (4) social agency referral services, (5) drug and alcohol treatment, (6) day care centers, (7) services for the elderly, (8) marriage counseling, (9) family planning, and (10) credit counseling assistance.

[b] This category includes (1) fraternities or sororities, (2) credit unions and mutual organizations, (3) veterans' organizations, (4) advocacy, (5) legislative and political activities, (6) litigation and legal aid activities, (7) cemetery or burial organizations, and (8) consumer product testing, among others.

SOURCE: Office of the Legislative Auditor's analysis of IRS activity codes for Minnesota tax-exempt organizations.

Table 2.5: Activities Conducted by Nonprofit Organizations that Received State Funds, by Percentage of State Agency Funds, 2005

	Percentage of State Funds Received by Nonprofit Organizations Engaged in Activity
Health services and related activities	29.9%
Education-related activities	19.1
Other activities directed to individuals[a]	10.0
Inner city or community activities	6.9
Housing activities	5.3
Other instruction or training activities	5.3
Youth activities and juvenile delinquency	4.9
Aid to charitable organizations	2.5
Other[b]	8.3
Missing	7.7

NOTES: Payments reflected in this table include state and federal funds provided by state agencies to nonprofit organizations for all purposes. Of the 3,178 nonprofit organizations that received state agency funds in 2005, 2,877 were in the IRS database. Of these organizations, 2,257 had IRS activity code information. Activity codes describe the work of the organization generally rather than the specific services they provide to the state. Nonprofit organizations can have up to three activity codes. This analysis excludes hospitals, health care systems, health plans, medical groups, hospice organizations, nursing homes, assisted living facilities, schools, libraries, ambulance services, volunteer firefighter organizations, and the Minnesota Historical Society.

[a] This category includes (1) providing funds or services to the poor, (2) gifts or grants to individuals other than scholarships, (3) job training or counseling, (4) social agency referral services, (5) drug and alcohol treatment, (6) day care centers, (7) services for the elderly, (8) marriage counseling, (9) family planning, and (10) credit counseling assistance.

[b] This category includes (1) employee or membership benefit associations; (2) scientific research; (3) religious activities; (4) cultural, historic, artistic, or other similar educational activity; (5) sports, athletic, recreational, and social activities; (6) conservation, environmental, and beautification activities; (7) advocacy; (8) veterans' organizations; and (9) fraternities or sororities, among others.

SOURCE: Office of the Legislative Auditor's analysis of IRS activity codes for Minnesota tax-exempt organizations.

3 Grant Policies and Administration

SUMMARY

Minnesota state government has a fragmented approach to grant management that results in inadequate oversight and accountability. Unlike for other types of contracts, the state has not implemented consistent policies and oversight requirements for grant contracts. As a result, state agencies have developed their own grant management policies and practices, which vary considerably and yield limited oversight. We reviewed 50 grants and found a wide range of management practices and performance, including inadequate publicizing of grant opportunities, insufficient financial oversight of grantee expenditures, and inadequate monitoring of grantees' activities. Oversight of legislatively-mandated grantees was particularly weak.

As discussed in Chapter 2, in 2005, Minnesota state government awarded almost $1 billion in grants to nonprofit organizations to provide an array of services.[1] Given the important role that nonprofit organizations play in the delivery of government services and the amount of funding paid to these organizations, it is natural to expect the state to have mechanisms to ensure that nonprofit organizations are using state funds appropriately and providing the desired services. In 2002, the Office of the Legislative Auditor (OLA) issued a special report on grants administration and found that state agencies did not consistently or adequately specify grant objectives, monitor grantee activity, or ensure compliance with reporting requirements.[2] In response to this and other OLA reports, some agencies made changes to their grant policies. However, we do not believe that enough has been done to improve the state's oversight of grants.

This chapter reviews the state's approach to grant management. Specifically, in this chapter, we address the following questions:

- **To what extent does Minnesota state government have consistent and effective grant management policies and procedures?**
- **How do state policies compare with those of other grant makers?**
- **How well do state agencies administer grants to nonprofit organizations?**

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[1] As discussed in Chapter 2, we excluded payments made to several types of nonprofit organizations, including schools, health plans, hospitals, nursing homes, and others.

[2] Minnesota Office of the Legislative Auditor, *Minnesota Grants Administration* (St. Paul, January 2002).

We evaluated the grant management policies and practices in six state agencies.

To answer these questions we focused on the grant management policies and practices of staff in six agencies: the departments of Education (MDE), Employment and Economic Development (DEED), Health (MDH), Human Services (DHS), Natural Resources (DNR), and Public Safety (DPS). We conducted a file review of 50 state grants with nonprofit organizations and interviewed the grant managers responsible for each grant. We also met with staff from two Minnesota foundations – the McKnight Foundation and the Bush Foundation, as well as staff from the Minnesota Council on Foundations and the Minnesota Council of Nonprofits. Finally, we reviewed Minnesota statutes and the national literature regarding grant oversight and management practices.

GRANT MANAGEMENT EVALUATION CRITERIA

To assess Minnesota state government's approach to grant management, we developed the evaluation criteria presented in Table 3.1. These criteria are based on guidelines set forth in the Department of Administration's contract manual, recommendations made in previous OLA reports, conversations with staff from Minnesota foundations, conversations with staff from contract offices in other states, and a review of the national literature. These criteria, which can also be viewed as best practices, outline a grant management process that would help state agencies ensure that state grant funds are used efficiently and for the purposes intended. The criteria are briefly discussed below.

State Grant Policies

The state should implement some basic grant management standards.

While agencies do not need to manage grants in the exact same way, it is important for the state to implement some basic standards regarding how grants should be administered. State grant policies are needed to ensure a minimum level of agency oversight of grant funds and consistent treatment of grantees across state agencies. The state currently provides standards for professional/technical and service contracts through Minnesota statutes and Department of Administration policies. For example, Minnesota statutes outline requirements for these contracts regarding vendor solicitation and selection, contract terms and duration, amendment scope, and performance evaluations. These requirements are enforced by the Department of Administration, which must approve all professional/technical and service contracts, unless authority has been specifically delegated to staff in other agencies.

Some other states have established state grant management policies. In New York, all grants and contracts over $50,000 must be approved by the Office of the State Comptroller before they are final. In addition to submitting the grant contract to the state comptroller, agencies must demonstrate how they advertised the grant, disclose the award method and rank order of all applicants, and indicate the funding each applicant will receive. All of this information is reviewed by the State Comptroller's Office before a grant is approved. In Washington State, the Office of Financial Management provides some guidance regarding "client service contracts," which are contracts for third-party services, such as therapy, unemployment training, and other services provided directly to individuals. These client service contracts are comparable to many grants in Minnesota. For these contracts, Washington's Office of Financial Management writes contract guidelines and provides training as required by state law.

Table 3.1: Grant Management Evaluation Criteria

	Best Practices
State Grant Policy	The state grant policy should outline minimum requirements that strengthen grant management and promote consistency among state agencies. These policies should be enforced by an office with oversight authority.
Grant Announcement	Agency staff should publicize grants as broadly as possible, such as advertising them on agency websites, posting them in the State Register, mailing notices to target groups, and posting a notice on relevant listservs.[a] The grant notice should clearly identify the grant expectations and selection criteria.
Grant Award	Agency staff should award grants through a competitive application process at least once every five years.
Grant Application Review	A committee of agency staff and/or community members should review all applications using standardized scoring sheets with the selection criteria clearly outlined. All reviewers should sign a form asserting that they do not have a conflict of interest. Agency staff should review applicants' financial audits and other information regarding the organizational health of grant applicants.
Grant Contract	A contract should be written, with expectations clearly detailed. The contract should contain standard contract language, including clauses regarding data privacy, ownership of equipment, audits, and conditions of payment. Grant activities should not start until the contract is fully executed.
Grant Payment	Payments should be made on a reimbursement basis or for services rendered. Advance payments should be limited.
Grant Monitoring	Agency staff should conduct at least one formal site visit of all grantees during the contract period. This site visit should include a review of the organization's activities and services provided. Agency staff should develop a checklist to use during the site visit for each grant program. Site visits should be documented. Agency staff could use a risk analysis tool to determine which grantee site visits should be given priority. Agency staff should conduct a financial reconciliation of grantees' expenditures at least once during the contract period for contracts over $50,000. This should include reconciling a request for payment from a sample quarter with supporting documentation.
Performance Reports	All grantees should be required, at a minimum, to submit six-month progress reports outlining the services provided and documenting any changes to the program.
Grant Closeout	At the end of a contract, staff should review the services provided and write an assessment of the grantee. These assessments should be considered when awarding subsequent grants.

[a] *Minnesota Statutes* 2006, 15.994 requires all state agencies to post grant opportunities on their website.

SOURCES: Office of the Legislative Auditor, based on: grant management activities in the Bush and McKnight Foundations; Minnesota Department of Administration, *State Contracting* (St. Paul, May 2002); and Domestic Working Group Grant Accountability Project, *Guide to Opportunities for Improving Grant Accountability*, http://www.ignet.gov/randp/grantguide.pdf; accessed April 5, 2006.

Grant Announcement and Award Process

State agencies should award grants through a fair and open process.

When a grant becomes available, state agencies should publicize notice of the grant as broadly as possible to ensure that all eligible applicants are aware of the opportunity. By law, state agencies are required to post information about grants on their agency website, and in its contract manual, the Department of Administration states that "grants distributed by an agency should be done in a fair and equitable manner, which is usually done through some form of public notice."[3] In addition to being widely publicized, the grant notice should clearly identify the grant expectations and set forth the grantee selection criteria. This allows potential grantees to better evaluate whether they want to compete for a specific grant. These recommended practices are outlined in the Department of Administration's contract manual. Staff from the Minnesota Council of Foundations also indicated to us that they think selection criteria should be written as clearly as possible for grants awarded through a competitive process.

To the extent possible, state agencies should use a competitive process to award grants. This ensures that all eligible applicants have an equal opportunity to receive the grants and helps the state identify the most qualified organization to provide the desired services. In its contract manual, the Department of Administration recommends that agencies use a competitive grant process with a request for proposal (RFP) to ensure that the grant award process is as fair and open as possible. The Grant Accountability Project, a "collection of Federal, State, and local audit organizations tasked by the Comptroller General of the United States' Domestic Working Group to offer suggestions for improving grant accountability," also encourages competition for grants as a means to promote "fairness and openness in the selection of grantees."[4] In previous reports, our office has also recommended that agencies award grants using a competitive process to ensure fair and equitable access to grant funds.[5]

Grant Application Review

People that review grant applications should confirm that they do not have a conflict of interest in the awarding of a grant.

The grant application review is an important part of an agency's competitive grant award process. Prior to participating in a grant application review process, reviewers should confirm that they do not have a conflict of interest in the awarding of a grant. A conflict of interest occurs when a grant application reviewer has outside interests that influence his or her decisions or actions. For example, a conflict of interest would occur if a reviewer had a close relative who was the executive director of one of the organizations applying for a grant. Minnesota conflict of interest statutes require state employees to protect themselves and their state agency from even the appearance of a conflict of interest.[6] The Department of Administration's contract manual addresses conflict

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[3] *Minnesota Statutes* 2006, 15.994; and Department of Administration, *State Contracting* (St. Paul, May 2002), sec. 24, 1.

[4] Domestic Working Group, Grant Accountability Project, *Guide to Opportunities for Improving Grant Accountability*, http://www.ignet.gov/randp/grantguide.pdf; accessed April 5, 2006.

[5] Office of the Legislative Auditor, *Minnesota Department of Education and Metropolitan Educational Cooperative Service Unit Administration of Grant Funds* (St. Paul, October 2004), 5; and Office of the Legislative Auditor, *Special Review: State and City Contracts with the Minnesota Council on Compulsive Gambling* (St. Paul, June 2005), 18.

[6] See *Minnesota Statutes* 2006, 10A.07; 15.43; 16C.04; 43A.38; and 471.87.

of interest concerns for those involved in the grant process. Requirements to avoid a conflict of interest apply to everyone involved in the grant process, including both state employees and outside reviewers.

Agency staff should verify that they are awarding grants to financially sound organizations.

As part of the grant application review, agency staff should evaluate an organization's financial information and other indicators of the organization's health. It is important that agencies verify that they are awarding state grants to grantees that are financially and organizationally sound. Review of this information is an important part of the grant award process for both the Bush and McKnight Foundations. Staff from these foundations and from the Minnesota Council of Foundations emphasized the importance of verifying an organization's financial health before awarding it a grant. Similarly, in a previous report, our office recommended that agencies more stringently review potential grant recipients to ensure that they have adequate financial oversight and appropriate internal controls to properly administer grant funds.[7] The Grant Accountability Project also recommends that agencies assess the financial capabilities of organizations before making final grant award decisions.[8]

Grant Contract

All grant contracts should be written and include clear expectations and payment terms.

As is the case whenever the state contracts with the private sector, all grant contracts should be written with the expectations and payment terms clearly detailed. This helps the state and grantee understand the purpose of the grant and which services are to be provided. As the Department of Administration's contract manual states: "A grant contract must be written for every grant. It is essential to write clear duties and expectations of the grantee into the grant contract."[9] In addition, all state grant contracts should include the standard state contract language used for all types of contracts, including clauses regarding data privacy, audits, conditions of payment, and ownership of equipment.[10] This provides the state with the same protections for its grant contracts that are in place for other types of contracts. Finally, as required by law, agency staff should not permit organizations to provide services until the grant contract is fully executed.[11]

Grant Monitoring and Payment

Agency staff should conduct a formal site visit of all grantees at least once during the contract period. This would allow agency staff to verify that the grantee is providing the expected services and meeting the objectives of the grant. In addition, agency staff should use a formal evaluation tool to help guide the site visit. This tool should address issues such as whether organizations are (1) providing appropriate services, (2) properly documenting their activities, and (3) making allowable expenditures. Previous reports by our office recommended

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[7] Office of the Legislative Auditor, *Administration of State Funds by the African American Mentor Program, Inc.* (St. Paul, July 2004), 15.

[8] Domestic Working Group, *Guide to Opportunities for Improving Grant Accountability*, 17.

[9] Department of Administration, *State Contracting*, sec. 24, 3.

[10] If the county is the contracting agency, the overseeing state agency should encourage counties to use a contract similar to the state's standard contract.

[11] *Minnesota Statutes* 2006, 16C.05.

Agency staff should actively monitor grantees through site visits, progress reports, and financial reconciliation of payment requests.

that agencies perform periodic site visits of grantees, and the Department of Administration's contract manual suggests that agencies conduct site visits of grantees using a checklist as one way to monitor grantees' performance.[12] The Grant Accountability Project also recommends that agency staff conduct site visits to effectively monitor grants. In addition, this group recommends that agency staff use a risk analysis tool to prioritize and manage its grant oversight.[13]

Either as part of the formal site visit or as a separate activity, agency staff should reconcile receipts and other financial documentation with a randomly selected request for payment at least once during the grant period. Grantees should be able to provide documentation for any expenditure made through a state grant. Financial reconciliation of payment requests with supporting documentation would help agencies verify that grantees are using grant funds as intended. As with other criteria mentioned above, our office through previous reports, the Department of Administration, and the Grant Accountability Project recommend this practice.

Grantee organizations should submit progress reports at least every six months that identify the services provided and any challenges that arose. This would help to keep the grant manager informed of the organization's grant activities. At the end of a grant contract, agency staff should review the services provided by the organization and assess the grantee's work. This review of the organization should be used in subsequent grant application review processes. Staff from the McKnight and Bush Foundations indicated that grantees are required to submit end-of-grant reports for all grants awarded by these foundations. Staff from the Minnesota Council of Foundations also recommended that foundations receive a report from their grantees at the end of a grant. Staff from these organizations said that a grant manager's review of a grantee's performance can factor into future grant award decisions.

Payments to grantees can be made in a variety of ways, including on a reimbursement basis, as payment for services rendered, or in a lump sum on scheduled dates. To the extent possible, payment to grantees should be made on a reimbursement basis or for services rendered. This allows the overseeing agency to have the most control over how grant funds are used. While there may be times when it is necessary to provide an advance to a grantee organization, advances should be limited and awarded only on the basis of demonstrated need. (An advance is when payment is made before the work is performed.) Once an agency gives a grantee an advance, the state has much less control over how the organization uses those funds. In its contract manual, the Department of Administration discourages the use of advances.[14]

GRANT MANAGEMENT

Overall, we found that:

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[12] Office of the Legislative Auditor, *Administration of State Funds by the African American Mentor Program, Inc.*, 15; and Department of Administration, *State Contracting*, sec. 24, 11.

[13] Domestic Working Group, *Guide to Opportunities for Improving Grant Accountability*, 25-27.

[14] Department of Administration, *State Contracting*, sec. 24, 9.

- **The state's approach to managing grants to nonprofit organizations is fragmented and inconsistent and does not provide adequate accountability.**

We found problems at all levels of the state's grant management system. Specifically, we found a lack of state policies and oversight, varying and insufficient agency policies, and inadequate grant management practices. Each of these is further discussed in the sections below.

State Policies

The evaluation criteria (best practices) outlined in Table 3.1 call for a state grant policy that promotes grant management standards and ensures a level of consistency in how agencies manage grants. For some types of contracts, specifically service and professional/technical contracts, the state has implemented policies and procedures that state agencies must follow.

However, we found that:

- **Unlike for most other state contracts, Minnesota has not implemented consistent policies and procedures or oversight requirements for grant contracts.**

The Department of Administration suspended its grant oversight role in 1992.

The Department of Administration's oversight of grant contracts differs significantly from that for professional/technical and service contracts. State statutes require that the Department of Administration approve these other contracts, but they allow the department to choose whether to approve grant contracts.[15] Currently, the Department of Administration does not approve other agencies' grant contracts or oversee them in any manner. The Department of Administration previously reviewed and approved state grant contracts, but it stopped this direct oversight in 1992.[16]

State statutes and the Department of Administration's contract policies provide some broad standards for grant management, but they are not enforced. One section in the Department of Administration's contract manual specifically addresses grants.[17] This section includes a grant contract template, general guidance for drafting grant contracts, and guidelines for soliciting grant applicants and monitoring grantees' performance. While Administration staff told us these policies should be considered "directives" rather than suggestions, staff also acknowledged that they do not review agencies' practices to ensure that these policies are being implemented.

This lack of oversight is particularly important since agencies manage significantly more money through grants than through professional/technical contracts. As discussed in Chapter 2, state agencies spent about $1 billion on

[15] The department may choose, but is not required, to oversee the following types of agreements: grant contracts, interagency agreements, purchase orders, work orders, and annual plans. See *Minnesota Statutes* 2006, 16C.05.

[16] According to agency staff, the Department of Administration stopped its oversight of grant contracts as part of an effort to prioritize its oversight activities.

[17] Department of Administration, *State Contracting*, sec. 24.

grants to nonprofit organizations in 2005.[18] Agencies also make grants to other entities, such as for-profit and government organizations, that are not included in this figure. In contrast, state agencies spent just over $354 million on all professional/technical contracts during the same time period.

As discussed in Chapter 2, the primary difference between professional/technical contracts and grants is that contracts are used when the state is the recipient of the service or product. In contrast, grants are used when a service is provided to a third party or community, rather than the state. Some agency staff with whom we spoke emphasized the range of services provided through grants as evidence of their complexity and justification for the lack of standardized practices. Staff felt that program-area expertise was necessary to effectively oversee grants, and that standardized practices could not accommodate program differences. In our opinion, the differences between grants and professional/technical contracts do not justify having less state oversight of grants, especially given the amount of state funds that are awarded through grants.

Governor Pawlenty's Drive to Excellence found that "there are no statewide standards in grants management policies, practices and supportive systems."

Several years ago, grant managers in Minnesota state agencies recognized the lack of consistent state grant administration policies and formed the Enterprise Grants Management Community. This group of state grant managers meets several times each year to collaborate on grants management and share best practices across agencies. This group also provided input to the grants management initiative included in Governor Pawlenty's "Drive to Excellence."

The grants initiative of the Drive to Excellence focused on the lack of a consistent statewide grant management process. Specifically, the initiative found: "There are no statewide standards in grants management policies, practices and supportive systems. This lack of consistency causes inefficiency in the administration of grants programs. . . ."[19] Among other things, the project proposed creating an Office of Grants Governance in the Department of Finance. In an effort to improve consistency, this office would develop grant management policies and procedures that would apply to all state agencies.

Agency Policies

In the absence of comprehensive state grant management policies, agencies have developed their own grant policies. In general, agencies do not have separate policies for working with nonprofit organizations; rather, grant policies are the same for all entities, regardless of their status. We reviewed grant management policies for six state agencies: MDE, DEED, MDH, DHS, DNR, and DPS. In addition to reviewing written agency policies, we interviewed staff in the contract and financial management divisions of these six agencies regarding grant management policy. We also reviewed the grant policy and interviewed staff from the Legislative-Citizen Commission on Minnesota Resources (LCCMR), which works closely with DNR on some grants. Based on our review, we found that:

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[18] About $300 million of the $1 billion Minnesota spent on grants to nonprofit organizations was paid through "traditional" grants. Much of the remainder was spent on medical services provided to individuals through contracts largely managed by counties.

[19] State of Minnesota's Drive to Excellence, *Annual Report to the Governor* (St. Paul, December 15, 2005), 41.

- **Many state agencies have grant-making policies and procedures, but they vary considerably in the degree to which they provide for oversight and accountability.**

The agency policies we reviewed each set forth different grant management expectations. Some agencies' policies outline detailed grant management requirements (MDE, DHS, and DPS), while one agency has no agency-wide grant management policy (DNR). Table 3.2 summarizes the grant management policies for the six agencies included in our review. We limited the information in the table to written, agency-wide grant management policies; however, some agencies have grant management practices that are not reflected in written policy. In addition, some agencies have written grant policies for specific grant programs or divisions, but they are not implemented on an agency-wide basis.

Most of the grant policies we reviewed provide for limited oversight and accountability of the grant award process.

As shown in Table 3.2, most of the agency policies we reviewed provide little guidance on the grant award process. Specifically, most policies do not address several of our evaluation criteria, including how frequently on-going grants must be competitively awarded and how conflict of interest issues should be addressed. Most of the policies we reviewed also do not require agency staff to assess a potential grantee's organizational health through a review of financial audits, financial statements, or other information. The exception is MDE's policy, which requires grant applicants to submit financial and governance documentation, such as a financial audit, a list of board members, a copy of recent board meeting minutes, and a copy of the most recent federal tax return with their grant application.[20] In our opinion, most of the policies we reviewed provide for limited oversight and accountability of the grant award process.

Table 3.2 shows that most, but not all, of the agencies we reviewed have agency-wide standard grant contracts based on the Department of Administration's grant contract template. DNR does not have an agency-wide standard contract although the department has developed a standard contract for use with all of the LCCMR grants it administers. Similarly, DEED has no standard grant contract, but its policy requires that specific elements be included in a grant contract. Although those agencies with standard contracts base them on the Department of Administration's contract template, the contracts vary regarding key provisions. For example, MDE's grant contract omits a clause stating that payment is conditional upon satisfactory performance by the grant recipient. In other cases, agencies' standard grant contracts include language regarding when the state or grant recipient can cancel the contract, but the reasons for cancellation and the number of days of notice required vary. In our opinion, the basic grant contract clauses should be standard across state agencies.

While several of the agencies we reviewed have grant policies that require payment on a reimbursement basis (as outlined in the evaluation criteria), most also permit advances for grantees. Awarding advances limits the state's ability to hold grantees accountable for their use of state funds. Table 3.2 shows that the

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[20] MDE staff indicated that the department adopted this policy in response to an investigation by our office. See Office of the Legislative Auditor, *Administration of State Funds by the African American Mentor Program, Inc.*

Table 3.2: Comparison of Six State Agency Written Grant Management Policies

Element of Grant Policy	MDE	DEED	MDH	DHS	DNR	DPS
Has an agency-wide grant management policy	Yes	Yes	Yes	Yes	No	Yes
Typically requires a competitive award process	Yes	No	No	Yes	No	Yes
Specifies how frequently on-going grants must be awarded competitively	No	No	No	Yes (5 years)	No	No
Addresses conflict of interest restrictions as they apply to the grant process	Yes	No	No	No	No	Yes
Requires applicants to submit financial or governance documents	Yes	No	No	No	No	No
Includes a standard agency-wide grant contract template	Yes	No[a]	Yes	Yes	No	Yes
Requires payment to typically be on a reimbursement basis	No	No	Yes	Yes	No	Yes
Permits advances/maximum amount	Yes/No[b]	Yes/No[c]	No policy	Yes/ 1 quarter	No policy	Yes/ 1 month
Requires monitoring such as site visits and performance reports	No	Yes	No	No[d]	No	No
Requires reconciliation of payment requests to supporting documentation	No	No	No	No[d]	No[e]	No

NOTES: This table describes only written agency-wide policies; however, in interviews, some agency staff mentioned that they have agency-wide practices that are not reflected in written policy. Although an agency policy may omit a policy element, that element may be in place for some programs within the agency. The following abbreviations are used in this table: MDE (Department of Education), DEED (Department of Employment and Economic Development), MDH (Department of Health), DHS (Department of Human Services), DNR (Department of Natural Resources), and DPS (Department of Public Safety).

[a] DEED does not have an agency-wide grant contract; however, its policies describe required elements for a grant contract.

[b] MDE's grant policy limits advances to start-up costs but requires only that the advance be less than the full amount of the grant.

[c] DEED's grant policy does not have a limit on the amount of an advance, but grantees may not request an advance more than three days prior to when they make grant expenditures.

[d] Although there are no monitoring requirements, DHS's policy discusses a variety of methods for monitoring, including performance reports, site visits, and review of financial audits. If a site visit is conducted, the policy states that grant managers should reconcile one monthly payment request with the grantee's financial records.

[e] DNR has no agency-wide grant policy, but its policy for Legislative-Citizen Commission on Minnesota Resources (LCCMR) grants requires grant recipients to submit supporting documentation, such as receipts and personnel timesheets, with all payment requests.

SOURCES: Office of the Legislative Auditor's analysis of grant management policies for the departments of Education, Employment and Economic Development, Health, Human Services, Natural Resources, and Public Safety.

grant policies for MDE, DEED, DHS, and DPS permit advances. MDH staff indicated that advances are permitted, although they are not addressed in the agency's written policy. Agency policies vary in the limit they set for the advance amount, ranging from one month of the total award (DPS) to a requirement only that it be less than the full amount of the award (MDE).

As shown in Table 3.2, most of the grant policies we reviewed do not require specific monitoring practices, such as reviewing grantee performance reports or conducting site visits. The absence of monitoring requirements can lead to limited oversight of state grants. For the LCCMR grants it administers, DNR requires that grant recipients submit supporting documentation, such as receipts and personnel timesheets, with all payment requests. This was the only such requirement in the agency policies we reviewed. While the DHS policy does not require site visits or financial reconciliation on an agency-wide basis, the policy states that, when a site visit is conducted, grant managers should compare one of the grantee's payment requests with supporting financial documentation.

Grant Management Practices

We evaluated state agency grant management practices for 50 grants.

In addition to reviewing agencies' grant policies, we also evaluated the grant management practices of staff in the six state agencies included in our review.[21] We selected 50 grants that these agencies made to nonprofit organizations. To be included in our sample, the agency must have paid the nonprofit organization in 2005. We selected nonprofit organizations that had received funding from state agencies for several years and those that were awarded new grants. For some organizations, we selected two grants—each made by a different state agency. We also selected nonprofit organizations that received large payments from the state, as well as some that received relatively small payments from the state. Finally, we made a point to select some grantees that were specifically named or described in law. The appendix at the back of the report lists the nonprofit organizations that received the 50 grants included in our review.

Five of the 50 grants selected for our review, all in DHS, were to nonprofit organizations that received funds through a state payment system but the grant contract was managed by a county. Although many of the factors we evaluated were not relevant for these five grants, we did review the state's oversight of these grants and the extent to which agency staff monitored counties' grant processes. In general, agency staff verified that these grantees had the appropriate licenses and required credentials, but did not oversee counties' management of these grants. At a minimum, we think that agency staff should provide guidance to county staff regarding effective grant management practices.

Based on our file review, we found that:

- **Minnesota state agencies provide inconsistent and sometimes inadequate oversight of grants to nonprofit organizations.**

Our file review evaluated all phases of the grant management process—from grantee selection to closing the grant. In almost all of these phases, we found that state agencies differ in their management of grants. Moreover, we often found that divisions within state agencies differ in how they manage grants. When we compared the grant management practices we observed through our file review to the evaluation criteria outlined in Table 3.1, we found that the state's management of grants was often inadequate. In the following sections, we discuss how agencies managed the grants compared to the evaluation criteria and best practices outlined in Table 3.1.

[21] As mentioned previously, the six agencies included in our review are: MDE, DEED, MDH, DHS, DNR, and DPS.

Grant Announcement and Award

> **State agencies should:**
>
> - Award grants through a competitive application process.
> - Advertise grants as broadly as possible, such as on the agency's website and in the State Register.

As illustrated in Table 3.3, the grants we reviewed were awarded through a variety of methods, many of which do not meet the evaluation criteria or reflect best practices. Of the 45 state-managed grants we reviewed in our sample, only 19 were awarded through a competitive process whereby interested organizations were required to submit an application. Fourteen of the grants we reviewed were awarded to previous recipients as ongoing grants, without a competitive selection process. Ten of the grants were legislatively-mandated, where the grant recipient was identified in statute, and the remaining two grants were awarded without a competitive process as "sole source" grants. A grantee is a sole source when it is the only organization reasonably capable of providing the requested services. We considered one of these sole source grants to be a true sole source. However, the other grant, managed by DNR, was awarded without a competitive process even though there were other organizations that could have provided the services.

Less than one-half of the grants we reviewed were awarded through a competitive process.

Table 3.3: Grant Award Methods for 45 Agency Grants

	Number of Grants
Competitive process with a request for proposal (RFP)	19
Continuation grant awarded to an existing grantee	14
Legislatively-named grantee	10
Sole source grantee[a]	2
Total	45

NOTE: This table shows the methods state agencies used when awarding the 45 state-managed grants included in our review.

[a] A grantee is a "sole source" when it is the only organization capable of providing the requested services.

SOURCE: Office of the Legislative Auditor.

In general, we think that ongoing grants should be the exception rather than the rule. Competition helps the state to ensure that it is receiving the best services for its money. However, there may be good reasons to award continuation grants to certain organizations. For example, several of the grants we reviewed in DPS were for battered women's shelters. Due to the nature of the services provided by these organizations, it is desirable to have the same organizations receive the grants on an ongoing basis. Agency staff spoke about the need to have continuity of these services and said that it takes time for these organizations to gain the trust of their clientele.

As a whole, state agencies did not adequately publicize grant opportunities for the grants that we reviewed. Although only 19 of the grants we reviewed were awarded through a competitive process, there were RFPs in 28 of the grant files we reviewed.[22] Despite requirements in law, only half of the 28 grants that had an RFP were publicized on the agency's website. Similarly, only half of the 28 grants with an RFP published a notice in the State Register. However, most grants were publicized either in the State Register or on an agency website. For one DHS grant we reviewed, agency staff did not publicize the grant but instead sent notices about the opportunity to organizations that were already providing similar services for other DHS programs. In our opinion, this did not provide adequate notice of the grant opportunity.

For those grants that did have an RFP, agency staff did a good job identifying the purpose of the grant. We rated the 28 RFPs on the extent to which the selection criteria and grant objectives were clearly identified. On a scale from one to five, where five is the highest, we rated the RFPs an average of 4.2 for identifying the objectives and 3.5 for stating the selection criteria clearly.

Grant Application Review and Selection

State agencies should:

- Have a committee review all applications using standardized scoring sheets with the selection criteria clearly outlined.
- Require all reviewers to sign a conflict of interest form.
- Require that agency staff review applicants' financial audits and other information to assess the organizational health of potential grantees.

For many of the grants we reviewed, agencies implemented best practices and used a committee of reviewers to select grantees. We found that the grantee selection process for several grants included in our sample followed a similar approach. Typically, the reviewers read the grant applications independently and scored each using a standardized scoring system (available in about two-thirds of the grants we reviewed with RFPs). The reviewers then met to discuss their rankings of the grant applicants. Through the discussion, the group came to a consensus ranking of all the applicants and made grant award recommendations to the granting agency.

Grant application reviewers completed conflict of interest forms for only eight of the grants we reviewed.

In contrast, agencies generally did not satisfy the evaluation criteria regarding conflicts of interest, which can contribute to inadequate oversight of state grants. Only 8 of the 28 grants we reviewed with an RFP had all reviewers sign a conflict of interest form. As mentioned previously, most of the agencies we reviewed do not address conflicts of interest in their grant policies. While agency policies are an important method for preventing conflicts of interest, we think it is also important for grant application reviewers to sign a form attesting that they do not have a conflict of interest in the awarding of a specific grant. Requiring grant reviewers to sign a form each time they participate in an application review process ensures that the potential for a conflict of interest has been considered.

For most of the grants we reviewed, agencies also did not meet the evaluation criteria regarding evaluating the health of a potential grantee before awarding a

[22] The nine grants that had RFPs but were not awarded competitively were continuation grants that had previously been awarded through an RFP.

grant. By not conducting this due diligence at the beginning of a grant, agencies could unintentionally award grants to organizations that are not financially sound. Only 6 of the 28 grantees that responded to an RFP in our review were required to submit a financial audit or a list of board members with their application; all but one of these grants were with DPS.

As noted previously, MDE currently requires grant managers to review financial audits and other information prior to awarding grants to nonprofit organizations. This policy was phased in throughout fiscal year 2006 and was not in place for most of the grants we reviewed. Nevertheless, most staff we spoke with from MDE felt that they were not equipped to review grantees' financial information and that they had not received adequate training in this area. One staff person felt that, because they were not sufficiently trained, reviewing financial information was simply a bureaucratic exercise, without adding any value or oversight to the grant management process.

Grant Contract

State agencies should:

- Require that contracts be written, with expectations clearly detailed.
- Require that contracts include the state's standard contract language.
- Ensure that grant activities do not start until the contract is fully executed.

Two grants we reviewed did not have a written contract; contracts for two other grants contained significant errors.

Most grants we reviewed had a standard written contract that parallels the state's professional/technical contract. However, two grants in our review, both with MDE, did not have a written contract. For one of these grants, department staff simply sent a letter to the grantee notifying the organization of the grant award amount. For another grant, MDE staff had a letter of assurance outlining the terms of the grant. However, the letter of assurance did not include any of the state protections included in a standard contract (such as the data privacy protections or audit clause). Two other grants we reviewed had contracts with significant errors. One of these grants, with DHS, had an incorrect contract that did not reflect the expected duties or payment methods for the grant. The second grant, with DEED, referenced an application and budget that did not exist.

Agency staff allowed work to start before the contract was fully executed for 28 of the 43 grants that we reviewed that had contracts.[23] This was the case despite state law and Department of Administration policies prohibiting work to start on a contract before it has been fully executed. Allowing work to start before a contract is fully executed is a chronic problem with state contracts. We also identified this problem during our 2003 and 1992 evaluations of professional/technical contracts.[24] Agency staff commented that it is often difficult to avoid having work start before a grant contract is fully executed. The

[23] As noted previously, two of the grants that we reviewed did not have contracts. One of these grants had no written agreement, and the other had only a letter of assurance, with no start date information. These two grants are not included in this discussion.

[24] Minnesota Office of the Legislative Auditor, *Professional/Technical Contracting* (St. Paul, January 2003), 43; and Minnesota Office of the Legislative Auditor, *State Contracting for Professional/Technical Services* (St. Paul, February 1992), 15-16.

state relies on some nonprofit organizations to provide ongoing services. Because the Legislature often approves budgets near the end of the state fiscal year, there is little time for agency staff to write, negotiate, and finalize grant agreements with these organizations. As a result, agencies sometimes tell organizations that they will be receiving a grant and ask them to continue to provide the services while the contract and other formalities are finalized.

Grant Monitoring

State agencies should:

- Require staff to conduct at least one formal site visit of all grantees during the contract period.
- Require staff to develop a checklist to use during the site visit for each grant program.

Providing thorough oversight of grantee organizations, such as reviewing how they provide services and manage their funds, is an important part of ensuring that state grant funds are used appropriately. However, the level of monitoring provided for the grants we reviewed varied widely. Agency staff conducted formal site visits for less than half of the grants we reviewed (19 of 45). For these 19 grants, agency staff conducted regular annual or biennial site visits that included a review of the services provided and/or a review of the financial aspects of the grant program. In some instances, more monitoring occurred for those grants that also received federal funding. In these cases, federal funding provided support for grant management and oversight.

For some of the grants we reviewed, agency staff had developed site visit checklists. For example, staff in the Office of Economic Opportunity in DHS use a monitoring checklist when they conduct their biennial site visit of grantees. Included on the checklist are things such as: (1) reviewing program files to verify that program participants are eligible for the services; (2) reviewing program documentation to ensure that the grantee is providing appropriate services to the clients; (3) verifying that a sample of reported expenditures are supported by appropriate documentation, such as invoices and receipts; and (4) verifying that expenditures are eligible.

Similarly, staff in the Family Planning Special Projects Division in MDH use a monitoring tool when conducting site visits of their grantees. The monitoring tool includes (1) reviewing the goals and methodologies of the grant program, (2) reviewing specific grant activities that took place in the past six months, (3) reviewing outreach activities, and (4) ensuring that appropriate program protocols are in place.

Agency staff did not conduct formal site visits for 26 of the grants we reviewed.

In contrast, agency staff did not conduct formal site visits for 26 of the grants we reviewed. Staff for many of these grants indicated that they have regular contact with these grantees through phone calls or when providing technical assistance. While these frequent contacts provide a general sense of how the grantee is performing, they do not provide the same rigorous level of oversight as a formal site visit. Our 2002 report on grant administration also found that “agencies did not consistently or adequately monitor grantee activity throughout the grant period."[25]

As mentioned in Table 3.1, agency staff could develop a tool to assess the potential risk of grantees and prioritize grantee site visits. Staff in the Office of Economic Opportunity in DHS have developed a risk analysis tool that helps identify which grantee organizations should be given priority for site visits. Factors such as having significant staff turnover, not having a recent formal site visit, and repeatedly requesting deadline extensions for audits and reports are some indications that an organization should receive a formal site visit.

Financial Oversight

State agencies should:

- Require staff to conduct a financial reconciliation of grantees' expenditures at least once during the contract period.

For most of the grants we reviewed, agency staff did not adequately ensure that organizations used the grant funds as intended.

As with the other aspects of grant management we reviewed, agency staff varied in the extent to which they reconciled grantees' payment requests with supporting documentation. For most of the grants we reviewed, agency staff did not adequately ensure that organizations used the grant funds as intended. For five of the grants we reviewed, all at DNR, agency staff required documentation to support every reimbursement request submitted. Agency staff reconciled a sample of reimbursement requests for five other grants we reviewed. Staff for several other grants reviewed some financial information during site visits or desk audits, but did not formally reconcile expenditures with supporting documentation. For 14 of the 45 grants in our sample, agency staff did not review any financial information to verify that grantees appropriately used the grant funds.

DPS has implemented an electronic grants management system, the Web-Enabled Grants Operations System (WEGO), which some of its divisions use to help monitor grant expenditures.[26] WEGO is a web-based grant management system that allows both agency and grantee staff to access and update information related to a grant. Grantees electronically submit financial status reports of expenditures, and agency grant managers can review the reports and additional expenditure details on WEGO. Agency staff can approve expenditures directly in the system or make a note indicating that more information is required. The grant management system also verifies calculations and ensures that grantees have submitted required status reports before receiving reimbursements. While WEGO does not replace the need for conducting regular financial reconciliations of grant expenditures, it has facilitated the department's oversight of grants. DPS staff with whom we met said that WEGO has helped significantly with their grant management process by giving them more time to provide technical assistance and conduct grantee site visits.

[25] Office of the Legislative Auditor, *Minnesota Grants Administration*, 21.

[26] The Crime Victim Services Unit within the Department of Public Safety also requests that organizations submit grant applications and quarterly reports through WEGO.

Payment

> **State agencies should:**
>
> - Require that payments be made on a reimbursement basis or for services rendered. Advance payments should be limited.

Two grantees included in our review received the full amount of the grant as an advance.

While most of the grantees included in our review were paid on a reimbursement basis, over one-quarter received an advance from the granting agency; this practice varied by agency. For example, DNR did not provide advances for any of its grants that we reviewed. In contrast, MDE and MDH provided advances to one-half of the grantees we reviewed in each agency. Two grantees included in our review, one with DEED and one with DHS, each received the full amount of the grant as an advance. In our 2002 report on grant administration, we also found that a large number of grantees received an advance. In that report we noted that "providing cash in advance limits an agency's influence over nonperforming or underperforming grantees."[27]

Differences Within Agencies

In addition to differences in grant management across agencies, we found different practices within agencies. For example, we reviewed three grants from MDH that were for the same grant program. Because there were different grant managers for the grantee organizations we reviewed, the monitoring practices differed. One of the grantees was required to submit documentation of expenses, while another grantee was not required to submit any such documentation.

We also saw differences in the use of conflict of interest forms within agencies. For example, one grant manager in DHS said that her division requires grant application reviewers to complete a conflict of interest form for all competitive grants awarded through an RFP. In contrast, another grant manager in DHS said that she had not used a conflict of interest form for her grants but thought it was something she would like to implement going forward. We also saw differences in the extent to which grant managers within DHS conducted site visits and financial reconciliations of grant expenditures.

LEGISLATIVELY-MANDATED GRANT RECIPIENTS

While agencies typically select grant recipients, some grantees are named by the Legislature in appropriations bills. In other cases, the Legislature narrowly defines eligible grant recipients, thus limiting an agency's ability to competitively award a grant. When a grantee is legislatively-mandated, the Legislature directs an agency to provide grant funds to that specific nonprofit organization. Based on our review of grants and interviews with agency staff, we found that:

- **Agency oversight of grant recipients is especially weak when the Legislature selects and mandates a recipient in law, rather than allowing the agency to select the recipient.**

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[27] Office of the Legislative Auditor, *Minnesota Grants Administration*, 15.

Agency staff often treat legislatively-mandated grantees differently than other grantees and provide even less oversight.

While only 10 of the 45 grants we reviewed had legislatively-mandated grantees, we found that agency staff often treated these organizations differently than other grantees. On the whole, agencies were less likely to monitor the performance of legislatively-mandated grantees than that of other grant recipients. Agency staff were less likely to require work plans for these organizations (50 percent compared with 71 percent for other grantees) and were more likely to provide advances (40 percent compared with 23 percent). Agency staff were less likely to require legislatively-mandated grantees to submit interim reports (50 percent compared with 69 percent for other grantees). Grant managers were also less likely to conduct site visits of legislatively-mandated grantees (30 percent compared with 46 percent for other grantees).

Agencies differed in their treatment of legislatively-mandated grants, as they did for other types of grants. For some of the grants we reviewed, agency grant managers closely monitored grant expenditures of legislatively-mandated grantees. For example, DNR required a legislatively-named grantee to provide receipts and documentation to receive reimbursement for all expenditures. Similarly, DEED provided funds to a legislatively-named grantee on a reimbursement basis and then reconciled some sample reimbursement requests with receipts. In other cases, grant managers provided limited monitoring of legislatively-mandated grantees. For example, DEED disbursed the full amount of grant funds to a legislatively-named grantee in one lump sum rather than on a reimbursement basis, and MDE provided virtually no oversight of one of its legislatively-named grant recipients.

While staff from some agencies asserted that they do not treat legislatively-mandated grantees differently than other grantees, staff in other agencies said they provide less oversight of these grant recipients. Staff cited several reasons for providing less oversight of legislatively-mandated grantees. Agency staff said that, because legislatively-mandated grantees are awarded funds by law, the agency's enforcement authority over these grantees is unclear. Staff stated that, when they try to require actions of legislatively-mandated grantees, these grantees sometimes consult legislators to pressure the agency to provide their grant funds. Staff also expressed frustration that legislatively-mandated grants undermine the agency's role in the selection and oversight of grants. For example, grant managers may develop monitoring practices for a grant program and deny funds to an organization that fails to comply. If the Legislature later provides funds directly to that organization, it undermines the agency's monitoring efforts. In an investigation of misuse of state funds by a legislatively-mandated grantee, our office recommended that the Legislature refrain from specifying grant recipients in legislation, noting similar concerns from agency staff.[28]

RECOMMENDATIONS

To improve the state's management of grants to nonprofit organizations, we present several recommendations. At a minimum, these recommendations apply to all "traditional" state grants that are administered by state agencies. To the extent possible, these recommendations should also be implemented for all grants

[28] Office of the Legislative Auditor, *State and City Contracts with the Minnesota Council on Compulsive Gambling*, 18.

made through the state's payment system, whether the state or the county is the responsible party.

Establish a Grants Management Office

RECOMMENDATION

To strengthen accountability and improve management of state grants, the state should establish a Grants Management Office in the executive branch.

By having a centralized grants management function in state government, Minnesota can improve consistency across agencies and achieve some efficiencies. Rather than having efforts to improve grant management duplicated across all of Minnesota's state agencies, these efforts should be in one office with both the expertise and the authority to identify and implement best practices. The grants initiative of the Drive to Excellence proposed establishing a similar grants office in the Department of Finance. The functions of the office recommended in this report could be implemented by Finance or the Department of Administration, which performs a somewhat parallel role for state contracts. We anticipate that this office would require two or three staff to fulfill its responsibilities. Once the recommendations to improve consistency and efficiency are implemented, we anticipate a commensurate reduction in grant management personnel across state agencies.

While the evaluation criteria identified in this report are a starting point, the Grants Management Office would be responsible for identifying best practices regarding all grant management functions, such as how to select and monitor grantees, conduct compliance reviews, and provide financial oversight. The office would also provide training to grant managers on implementing the best practices, with an emphasis on how to review grantees' financial information and conduct financial reconciliation reviews. Several grant managers with whom we met said it would be helpful to have guidance on how to review financial audits.

Similar to what was proposed through the Drive to Excellence initiative, this office would also coordinate other state efforts to increase consistency and efficiency in grant management. This would include, but not be limited to, establishing a statewide electronic grants management system and creating standard grant contracts, RFPs, and grant report forms. The office would also be responsible for identifying what information agencies should request and review before awarding grants.

In addition to providing resources regarding best practices, this office would have compliance personnel with the authority and ability to audit grants and ensure that funds are being spent as intended. The compliance personnel would also have the authority to review agencies' policies and practices. While this office would not have final approval authority over agencies' grants, the office would be responsible for ensuring that agencies have implemented proper grant management policies and that agency staff are complying with them.

Finally, this office could also work with nonprofit organizations to help them be more prepared to receive and manage state grant awards. Several agency staff with whom we met said that they wished they had more time to help nonprofit organizations develop their financial and organizational capacity. Staff indicated that there is a need to help nonprofit organizations, especially smaller ones, with general grant management skills. The Office of Economic Opportunity (OEO) in DHS created a training manual and video to help nonprofit organizations and their boards better understand their responsibilities. OEO staff believe that helping the organizations run more efficiently helps to ensure that the state's grant funds are used more effectively. The Grants Management Office could build on the OEO materials to provide assistance to other nonprofit organizations.

Create a Standard Grant Contract

RECOMMENDATION

To ensure that agencies use complete and appropriate grant contracts, the Grants Management Office should prepare and require the use of a standard grant contract that includes, among other things, clauses regarding:

- ***ownership of equipment and intellectual property,***
- ***data privacy,***
- ***audits,***
- ***liability,***
- ***workers' compensation insurance,***
- ***contract cancellation, and***
- ***satisfactory performance as a condition of payment.***

The Grants Management Office should create a standard grant contract that includes all of the protections given to state agencies when they use the standard template for other types of state contracts. The grant contract template in the Department of Administration's contract manual provides a good foundation for a statewide standard grant contract that all agencies should be required to use.

As part of its review of agency policies and practices discussed above, the office should ensure that agencies use the standard grant contract. At a minimum, all grantees should sign a document that contains the state's standard contract language regarding ownership of equipment, data privacy, audit requirements, and other protections the state has in place when working with the private sector. The grant contract should also include the duties the grantee organization is expected to perform and outline the terms of payment.

As an expedited alternative to the standard grant contract, the Grants Management Office could develop a "master grant contract," which is pre-approved and contains the state's standardized grant contract language. Agency grant managers could include the master grant contract with the RFP for a given grant. Grantees would then be required to submit a signed master grant contract as part of their grant application. Once the agency selects the successful grantees, program staff could develop a list of duties and payment terms specific to the grant, which would be negotiated between the agency and each grantee. The Department of Health currently uses a master grant agreement similar to the master grant contract suggested above for some of its grant programs.

Implement Grant Management Best Practices

RECOMMENDATION

To ensure that the state manages grants effectively, the Grants Management Office should have the authority to formalize and require agencies to follow the best practices discussed in this report.

The evaluation criteria outlined in Table 3.1 are based on several reports by our office, Department of Administration guidelines, practices by Minnesota foundations, and the recommendations of the Grant Accountability Project. These criteria reflect best practices and are currently implemented by various state agencies. Agency staff have demonstrated that these grant management practices are reasonable and worthwhile.

The Grants Management Office should use its oversight role to ensure that agency staff implement these best practices. At the very least, agency staff should be expected to implement these best practices for grants managed by state agencies. For grants that are paid through the state's payment system but directly managed by a county, agency staff should encourage counties to meet the recommended practices.

Conduct Financial Reconciliation of Grant Expenditures

RECOMMENDATION

To verify that grantees are using state funds appropriately, all agency grant managers should conduct a financial reconciliation of a sample of grant expenditures at least once during the grant contract period for all grants over $50,000.

Uniformly, grant managers that we spoke with who conduct financial reconciliations of grant expenditures find the practice valuable. They believe that it provides a unique look at the organization's activities, helps them provide better technical assistance to the organization, and ensures that the organization is using state funds appropriately. These grant managers agreed that it is reasonable for the state to expect all grant managers to conduct a financial reconciliation of a sample of grant expenditures at least once during a grant contract period.

Because reconciling grant expenditures with supporting documentation is time-consuming, we are not recommending that grant managers reconcile all grant expenditures. However, we recommend that grant managers randomly select a request for payment submitted during a grant contract and reconcile the expenditures with supporting documentation. If there are questions or findings that result from this initial financial reconciliation, the grant manager should reconcile expenditures from additional randomly selected requests for payment. Our office has made similar recommendations in previous reports, and the Department of Administration also recommends reconciling grant expenditures in its contract manual.

As part of its oversight function, the Grants Management Office should ensure that financial reconciliations are conducted for all grants over $50,000 in value. We selected a $50,000 threshold for two reasons. First, we do not think it is necessary to conduct financial reconciliations for all grants – some are simply too small and do not warrant such time-intensive monitoring. The $50,000 threshold represents a point at which, we believe, the state should have increased oversight as to how state funds are being used. Second, all professional/technical contracts over $50,000 are subject to additional requirements from the Department of Administration, including submitting a certification form to the department and issuing a formal request for proposal (RFP).

Eliminate Legislatively-Mandated Grantees

RECOMMENDATION

To ensure an open and fair grantee selection process, the Legislature should not mandate grant recipients in law but allow agencies to select recipients through a competitive process.

As noted previously, oversight of legislatively-mandated grantees is not as robust as oversight of other grantees. Some agency staff we spoke with attributed these differences in part to the fact that these grantees are guaranteed funding regardless of their performance. These staff felt that when the Legislature directly names or describes a grantee, the agency has no leverage to require a certain level of performance or reporting because the grantees are guaranteed funding in law.

As outlined in the evaluation criteria, it is optimal to award grants through a competitive process. When the Legislature directly mandates grant recipients, it is not clear that the most qualified organization is being awarded the grant. As a result, we recommend that the Legislature not directly mandate grant recipients, and instead rely on agencies to conduct a competitive award process that ensures that grants are given to the most qualified organizations. To ensure that the Legislature does not mandate grant recipients, the Legislature could amend the Joint Rules of the Senate and House of Representatives to prohibit laws that appropriate grant funding to a specific organization. We think the proper place for this requirement is Joint Rule 2.02 of the Joint Rules of the Senate and House of Representatives, which outlines the rules governing appropriation legislation.

If the Legislature continues to identify specific grant recipients, it should clearly define the work required of these grantees. If the Legislature included performance requirements in the grant appropriation law, it would give agency staff some ability to hold these grantees accountable. Whether grantees are legislatively-mandated or not, they should all meet the same standards regarding the use of grant funds, reporting requirements, and performance. Agency staff should have the ability to withhold payment or require all grantees to meet a given standard, even if a grantee is directly named by the Legislature.

List of Recommendations

- To strengthen accountability and improve management of state grants, the state should establish a Grants Management Office in the executive branch (p. 39).

- To ensure that agencies use complete and appropriate grant contracts, the Grants Management Office should prepare and require the use of a standard grant contract that includes, among other things, clauses regarding: (1) ownership of equipment and intellectual property, (2) data privacy, (3) audits, (4) liability, (5) workers' compensation insurance, (6) contract cancellation, and (7) satisfactory performance as a condition of payment (p. 40).

- To ensure that the state manages grants effectively, the Grants Management Office should have the authority to formalize and require agencies to follow the best practices discussed in this report (p. 41).

- To verify that grantees are using state funds appropriately, all agency grant managers should conduct a financial reconciliation of a sample of grant expenditures at least once during the grant contract period for all grants over $50,000 (p. 41).

- To ensure an open and fair grantee selection process, the Legislature should not mandate grant recipients in law but allow agencies to select recipients through a competitive process (p. 42).

Grants to Nonprofit Organizations Included in File Review

APPENDIX

Organization Name	Services Provided	State Agency
African American AIDS Task Force	Eliminate health disparities in communities of color	Health
Ain Dah Yung	Tobacco use prevention for American Indians	Health
Anishinaabe Center	Eliminate health disparities in communities of color	Health
Brain Injury Association of Minnesota	Case management for people with brain injury	Health
Breaking Free	Advocacy services for women in the criminal justice system	Public Safety
Breaking Free	Fetal alcohol syndrome prevention services	Health
Downey Side, Inc.	Adoption services	Human Services
Ducks Unlimited	Build a fish barrier in Lake Maria	Natural Resources
Duluth Lighthouse for the Blind	Deaf/blind services	Human Services
Family and Children's Services	Services to women and youth in prostitution	Public Safety
Family and Children's Services	Eliminate health disparities in communities of color	Health
Great River Greening	Hunting and habitat restoration opportunities for youth	Natural Resources
HIRED	Dislocated worker services for mass lay-offs	DEED[a]
Hunger Solutions	Food shelves	Human Services
Learning Disabilities Association	Supplemental adult basic education services	Education
Let's Go Fishing of Minnesota	Boat excursions for senior citizens	Natural Resources
Lifeworks Services	Deaf/blind consumer directed services	Human Services
Light for Life Foundation	Suicide prevention efforts	Health
Living at Home Block Nurse	Aging community services	Human Services
Mankato Rehabilitation Center, Inc.	Coordinated employability services for people with serious and persistent mental illness	DEED
Mary T., Inc.	Residential and social services for people with special needs.	Human Services
Minnesota Center for Rural Policy	Research on issues affecting rural Minnesota	DEED
Minnesota Diversified Industries, Inc.	Center-based employment for individuals with disabilities	DEED
Minnesota International Health Volunteers	Family planning education for Somali population	Health
Minnesota Land Trust	Habitat preservation through the purchase of conservation easements	Natural Resources

Organization Name	Services Provided	State Agency
Minnesota Literacy Council	English Language civics classes	Education
Minnesota Organization on Fetal Alcohol Syndrome	Fetal alcohol syndrome prevention and intervention services	Health
Missions, Inc.	Battered women's shelter	Public Safety
Parents in Community Action	Head Start services	Education
PATH, Inc.	Adoption services	Human Services
Productive Alternatives	Coordinated employability services for people with serious and persistent mental illness	DEED
Project Turnabout	Compulsive gambling treatment	Human Services
Resource, Inc.	Re-entry services for women leaving prison	Public Safety
Resource, Inc.	Dislocated worker services for mass lay-offs	DEED
Sabathani Community Center, Inc.	Adult basic education services	Education
ServeMinnesota	Administer Minnesota's AmeriCorps program	Education
Sojourn, Inc.	Adult day care services	Human Services
Sustainable Resources Center	Lead hazard reduction	Education
The Center for Alcohol and Drug Treatment	Chemical dependency services	Human Services
The Minnesota Sharp-Tailed Grouse Society	Clear habitat for sharp-tailed grouse	Natural Resources
The Nature Conservancy	Habitat preservation through land acquisition	Natural Resources
The Wayside House, Inc.	Transitional housing	Human Services
Tubman Family Alliance	Battered women's shelter	Public Safety
Turning Point, Inc.	HIV case management	Human Services
Turning Point, Inc.	HIV prevention and outreach for African-American drug users	Health
Twin Cities Rise	Employment training for hard-to-train individuals	DEED
Violence Intervention Project	Battered women's shelter	Public Safety
Wacosa	Day training and habilitation	Human Services
WomenVenture	Provide assistance to low-income people starting their own business	DEED

NOTES: This table contains a listing of the 50 grants included in our file review. Organizations listed twice had grants with more than one agency included in our review.

[a] DEED refers to the Department of Employment and Economic Development.

SOURCE: Office of the Legislative Auditor.

Office of the Commissioner

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Minnesota State Patrol
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State Fire Marshal and Pipeline Safety

December 12, 2006

Mr. James Nobles
Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
St. Paul, Minnesota 55155-1603

Dear Mr. Nobles:

I have reviewed the State Grants to Nonprofit Organizations report prepared by your office. As Team Leader of Governor Pawlenty's Drive to Excellence Grants Management Project Steering Committee I was pleased to note that the recommendations of your report are consistent with those of the Drive to Excellence Grants Management Steering Committee.

Your report highlights the need for the establishment of a Grants Management Office in the executive branch that is charged with the development of consistent standards and procedures for the administration of grants by Minnesota state agencies. You also recommend that the office be given the authority to formalize and require agencies to follow best practices in the management of grants. Further you recommend that agency grant managers conduct financial reconciliation of a sample grant expenditures at least once during the grant contract period for all grants over $50,000 and that the Legislature not mandate grant recipients in law but allow agencies to select recipients through a competitive process. All of these recommendations are consistent with those developed by the Drive to Excellence Grants Management Steering Committee.

Thank you for the review of grant processes and procedures and the recommendations contained in the report. I look forward to working with your office and the legislature in furthering the goal of consistent professional management of grants to Minnesota nonprofit organizations.

Sincerely,

Mary Ellison

Mary Ellison
Deputy Commissioner

Further Reading

Domestic Policy Working Group, Grant Accountability Project, *Guide to Opportunities for Improving Grant Accountability*, http://www.ignet.gov/randp/grantguide.pdf; accessed April 5, 2006.

Minnesota Office of the Legislative Auditor, *Administration of State Funds by the African American Mentor Program, Inc.* (St. Paul, July 2004).

Minnesota Office of the Legislative Auditor, *Minnesota Department of Education and Metropolitan Educational Cooperative Service Unit Administration of Grant Funds* (St. Paul, October 2004).

Minnesota Office of the Legislative Auditor, *Special Review: Administration of State Funds by Women's Advocates, Inc.* (St. Paul, September 2003).

Minnesota Office of the Legislative Auditor, *Special Review: Department of Children, Families, and Learning Grant Administration* (St. Paul, March 2001).

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State of Minnesota's Drive to Excellence, *Annual Report to the Governor* (St. Paul, December 2005).

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Occupational Regulation, February 1999

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State Building Maintenance, February 1998

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Nursing Home Inspections, February 2005
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Public Health Care Eligibility Determination for Noncitizens, April 2006
Substance Abuse Treatment, February 2006
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