



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

FINANCIAL AUDIT DIVISION REPORT

Minnesota Historical Society

Internal Controls and Compliance Audit

July 1, 2009, through December 31, 2011

*The audit scope included the use of money appropriated from the
Arts and Cultural Heritage Fund.*

October 4, 2012

Report 12-20

FINANCIAL AUDIT DIVISION

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OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

October 4, 2012

Representative Michael Beard, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. D. Stephen Elliott, Director
Minnesota Historical Society

This report presents the results of our internal controls and compliance audit of selected financial activities of the Minnesota Historical Society for the period July 1, 2009, through December 31, 2011.

We discussed the results of the audit with the Minnesota Historical Society's staff on September 20, 2012. This audit was conducted by David Poliseno, CPA, CISA, CFE (Audit Manager) and Tracy Gebhard, CPA (Auditor-in-Charge), assisted by auditors Cynthia Gaertner, CPA, Heather Varez, and Melissa White.

We received the full cooperation of the Minnesota Historical Society's staff while performing this audit.

Handwritten signature of James R. Nobles in black ink.

James R. Nobles
Legislative Auditor

Handwritten signature of Cecile M. Ferkul in black ink.

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

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Report Summary

Conclusion

The Minnesota Historical Society's internal controls were generally adequate to ensure that it safeguarded its state appropriated financial resources, accurately paid employees and vendors in accordance with management's authorization, created reliable financial data, and complied with significant finance-related legal requirements, including requirements relevant to the Arts and Cultural Heritage Fund. However, the society had some control weaknesses related to contract awards for certain technical services and its outsourced payroll and human resources services.

For the items tested, the society generally complied with finance-related legal requirements, including requirements relevant to the Arts and Cultural Heritage Fund. However, the society had some instances of noncompliance in its grant activity and contract awards for certain technical services.

The society resolved the prior audit finding related to timely depositing and recording of state-owned historic sites' admission receipts.¹

Audit Findings

- Some Minnesota Historical Society grants did not comply with all of the society's grant policies. ([Finding 1, page 7](#))
- The Minnesota Historical Society did not have documentation to show how it considered technical criteria when awarding some contracts to vendors. ([Finding 2, page 8](#))
- The Minnesota Historical Society did not have a current contract for services related to its outsourced payroll and human resources service provider; the society also had not reviewed this service provider's most recent internal control audit. ([Finding 3, page 9](#))

Audit Objectives and Scope

Objectives

- Internal Controls
- Legal Compliance

Period Audited

July 1, 2009, through December 31, 2011

Programs Audited

- Selected Admission Fee Receipts
- Grant Expenditures
- Legacy Fund Expenditures
- Payroll Expenditures
- Selected Administrative Expenditures

¹ Office of the Legislative Auditor's Financial Audit Division Report 02-25, *Minnesota Historical Society*, issued May 2, 2002.

Minnesota Historical Society

Overview

In 1849, the Legislative Assembly of the Territory of Minnesota created the Minnesota Historical Society. The society exists today as a nonprofit organization whose mission is to “connect people with history to help them gain perspective on their lives.”² To achieve this mission, the society collects, preserves, and tells the story of Minnesota’s past through museum exhibits, libraries and collections, historic sites, education programs, and book publishing. The society operates the Minnesota History Center, which hosts both permanent and changing exhibits, concerts, lectures, and other special events throughout the year. The Minnesota History Center’s building is also home to the Minnesota Historical Society’s library and archives, a research destination for schoolchildren, family historians, and academics.

The society is directed by the executive council, its governing board, which is elected by the members of the society. The executive council appoints the executive director who has the responsibility to lead the society in accordance with the governing board’s policies. In March 2011, the executive council appointed D. Stephen Elliott as the executive director, replacing Nina Archabal who retired in December 2010 after serving in that capacity since 1987.

For fiscal years 2010 and 2011, the society’s receipts totaled about \$55 million and \$64 million, respectively. Included in those receipts were legislative appropriations to the society for operations and capital projects and appropriations from the Arts and Cultural Heritage Fund, one of the constitutionally established Legacy funds.³ The society also collected and deposited in the state treasury admission fees to state-owned historic sites operated by the society. (Other nonstate funding sources included federal grants, private sector donations, investment earnings, membership fees, and admission fees collected at the History Center and historic sites not owned by the state.)

² Although the Minnesota Historical Society is not a part of the state’s executive or judicial branches, *Minnesota Statutes* 2011, 3.971, subd. 6, establishes that the society is subject to audit by the Office of the Legislative Auditor.

³ In 2008, Minnesota voters approved the Outdoor Heritage, Clean Water, Parks and Trails, and Arts and Cultural Heritage Amendment to the Minnesota Constitution, commonly referred to as the “Legacy Amendment.” The amendment increased the state sales tax by three-eighths of 1 percent for a 25-year period beginning July 2009 and distributed the taxes among the Outdoor Heritage, Clean Water, Parks and Trails, and Arts and Cultural Heritage funds, which are collectively referred to as the Legacy Funds. The Arts and Cultural Heritage Fund receives 19¾ percent of the dedicated sales tax revenue, which must be used for arts, arts education, arts access, and preservation of Minnesota’s history and cultural heritage.

The society's total expenditures for fiscal years 2010 and 2011 were approximately \$48.5 million and \$57.2 million, respectively. Almost half of these expenditures related to the society's salaries and benefits. Other costs included grants, professional and technical contracts, building and improvements, and History Center building services. The society contracted with a CPA firm to perform an audit of its annual financial statements.⁴

The society used money appropriated from the Arts and Cultural Heritage Fund to provide grants; create statewide history programs, partnerships, cultural heritage exhibits, and a digital record of historical documents; and conduct statewide surveys of historical and archaeological sites. For fiscal years 2010 and 2011, the appropriation laws restricted the society's use of the funds for administrative purposes to 2.5 percent of the grant amounts; for fiscal year 2012, the law required administrative costs to be directly related to and necessary for the purposes of the appropriations.

Scope, Objectives, and Methodology

In determining the scope for this audit, we focused on the society's internal controls and compliance for its collection of state receipts and its use of money received through legislative appropriations (including money appropriated from the Arts and Cultural Heritage Fund.)⁵

Table 1, on page 5, shows the financial activity we selected for audit, for the period from July 2009 through December 2011.

The objective of our audit of the Minnesota Historical Society was to answer the following questions:

- Were the society's internal controls adequate to ensure that it safeguarded state appropriated financial resources, accurately paid employees and vendors in accordance with management's authorizations, produced reliable financial data, and complied with finance-related legal provisions, including provisions relevant to the Arts and Cultural Heritage Fund?

⁴ The Minnesota Historical Society's 2011 audited financial statements are available on its website at <http://www.mnhs.org/about/publications/index.html>.

⁵ Our audit scope also included the Minnesota Historical Society's costs related to its partnership with the state's 12 regional library systems to develop various statewide programs the libraries could provide to their communities. The regional library systems paid for these programs with grants from the Department of Education's appropriations from the Arts and Cultural Heritage Fund. Our audit of the Department of Education included these grants in its scope (Office of the Legislative Auditor's Financial Audit Division Report 12-17, *Department of Education*, issued August 23, 2012.)

Table 1
Appropriations, Revenues, and Expenditures Selected for Review
July 1, 2009, through December 31, 2011

	Fiscal Years ¹		
	<u>2010</u>	<u>2011</u>	<u>2012²</u>
Appropriations			
General Fund	\$23,037,000	\$23,719,000	\$25,518,060
Arts and Cultural Heritage Fund	9,750,000	12,250,000	12,050,000
Bond Proceeds Fund ³	<u>4,400,000</u>	<u>0</u>	<u>1,900,000</u>
Total	<u>\$37,187,000</u>	<u>\$35,969,000</u>	<u>\$39,468,060</u>
Revenues			
Admission Fee Receipts	\$ 1,057,496	\$1,117,777	\$ 597,551
Total	<u>\$ 1,057,496</u>	<u>\$1,117,777</u>	<u>\$ 597,551</u>
Expenditures			
Payroll	\$11,223,153	\$13,239,675	\$ 5,696,713
History Center Building Operations	4,400,345	4,215,345	2,495,931
Buildings and Improvements	3,718,250	1,031,697	892,112
Grants	2,354,822	7,321,135	575,017
Professional/Technical Services	<u>1,013,392</u>	<u>2,652,863</u>	<u>448,307</u>
Total	<u>\$22,709,963</u>	<u>\$28,460,715</u>	<u>\$10,108,079</u>

¹ The state's fiscal year is July 1 through June 30.

² Fiscal year 2012 revenues and expenditures only include financial activity through December 31, 2011.

³ Appropriations from the Bond Proceeds Fund use money generated by the state's sale of general obligation bonds to fund capital projects. The Historical Society received these appropriations for historic site asset preservation and local or county preservation, per applicable law.

Source: The state's accounting systems and the Minnesota Historical Society's accounting system.

- For the items tested, did the society comply with significant finance-related legal requirements, including provisions relevant to the Arts and Cultural Heritage Fund?
- Did the society resolve prior audit findings?⁶

To answer these questions, we gained an understanding of the society's financial policies and procedures. We considered the risk of errors in the accounting records and potential noncompliance with relevant legal requirements. We analyzed accounting data to identify unusual trends or significant changes in financial operations. We examined samples of financial transactions and reviewed supporting documentation to test whether the society's controls were effective and if the transactions complied with laws, regulations, policies, and grant and contract provisions.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

⁶ Office of the Legislative Auditor's Financial Audit Division Report 02-25, *Minnesota Historical Society*, issued May 2, 2002.

We used various criteria to evaluate internal controls and compliance. As our criteria to evaluating the society's controls, we used the guidance contained in the *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission.⁷ We used state laws, regulations, grant agreements, and contracts, as well as policies and procedures established by the departments of Management and Budget and Administration and the society's policies and procedures as evaluation criteria over compliance.

Conclusion

The Minnesota Historical Society's internal controls were generally adequate to ensure that it safeguarded its state appropriated financial resources, accurately paid employees and vendors in accordance with management's authorization, created reliable financial data, and complied with significant finance-related legal requirements, including requirements relevant to the Arts and Cultural Heritage Fund. However, the society had some control weaknesses related to contract awards for certain technical services and its outsourced payroll and human resources services.

For the items tested, the society generally complied with finance-related legal requirements, including requirements relevant to the Arts and Cultural Heritage Fund. However, the society had some instances of noncompliance in its grant activity and contract awards for certain technical services.

The society resolved the prior audit finding related to timely depositing and recording of state-owned historic sites' admission receipts.⁸

The following *Findings and Recommendations* provide further explanation about the exceptions noted above.

⁷ The Treadway Commission and its Committee of Sponsoring Organizations were established in 1985 by the major national associations of accountants. One of their primary tasks was to identify the components of internal control that organizations should have in place to prevent inappropriate financial activity. The resulting *Internal Control-Integrated Framework* is the accepted accounting and auditing standard for internal control design and assessment.

⁸ Office of the Legislative Auditor's Financial Audit Division Report 02-25, *Minnesota Historical Society*, issued May 2, 2002.

Findings and Recommendations

Some Minnesota Historical Society grants did not comply with all of the society's grant policies.

Finding 1

The process used by the society to administer its grants did not comply with all of its grant policies. These policies expressed the governing board's expectations about how society staff should administer and oversee grants. The society did not comply with the policies in the following ways:

- The society did not include certain required language in its agreements with recipients receiving grants of \$7,000 or less from the Arts and Cultural Heritage Fund. The society's grants manual required that all grant agreements contain language requiring compliance with the state statute that refers to the state's grants management process.⁹ Without the required language, the grantee may not be aware of the requirement to comply with the statute.
- For 12 of the 14 grants from the Arts and Cultural Heritage Fund we tested, the society did not obtain audited financial statements for grants with award amounts exceeding \$50,000. The society's grant policies and the specific grant agreements required the grantee to submit audited financial statements for the period the grant is active.
- The society did not ensure recipients of grants from the Arts and Cultural Heritage Fund did not begin work before the grant agreement was fully executed. For 4 of the 19 grants from the Arts and Cultural Heritage Fund we tested, grant recipients started work between 18 and 119 calendar days before the contract was fully executed. The society's grants manual prohibited the grantee from beginning work on a project before the grant agreement was fully executed. When a grantee incurs costs before the grant agreement is fully executed, there can be disputes about the terms and expectations of the agreement that could result in unintended uses of the grant funds.
- The society did not ensure that a peer review was completed for 2 of the 13 grants from the Arts and Cultural Heritage Fund we tested with amounts exceeding \$50,000. The society coordinates a peer review that is conducted by personnel who are not employed by the society and who are experts in the field for these grants. The society's grants manual required a peer review to be completed for each grant from the Arts and Cultural Heritage Fund with a grant amount exceeding \$50,000.

⁹ *Minnesota Statutes* 2011, 16B.98.

- The society did not prepare quarterly status reports for a subcommittee of the governing board or annual reports to the Legislature for its fiscal agent activities, as required by its policies.¹⁰ Without these reports, the board committee and the Legislature may not have current knowledge of the fiscal agent activity.

By not ensuring compliance with its policies, there is an increased risk that funds could be spent inappropriately by the grantees.

Recommendation

- *The society should establish controls to ensure staff comply with its grant management policies.*

Finding 2

The Minnesota Historical Society did not have documentation to show how it considered technical criteria when awarding some contracts to vendors.

The society did not have documentation to show how it evaluated some proposals for technical criteria when awarding certain contracts. For 7 of the 13 contracts tested that involved technical services (such as building restoration, masonry, mechanical, or information technology services) the society was not able to show how it evaluated or considered any criteria other than price to make its contract award decisions. In most cases, the society awarded contracts to the vendors that submitted the lowest bid. Without additional documentation, such as contract bid review sheets assessing each bid on technical criteria, the society cannot show that the low bids also represented the best value, considering both the quality of the services and the cost.

The society's policies required that proposals for complex items and services include specifications, drawings, or statements of work for the society to evaluate. The policy also required evaluators to complete a written recommendation for the choice of vendor, clearly stating the basis of the recommendation.

Recommendation

- *The society should document how it considered technical criteria when evaluating vendors' bids and awarding competitive contracts.*

¹⁰ As directed by the Legislature, the society acts as a fiscal agent for certain entities specified in law. In general, a fiscal agent is responsible for the receipt and expenditure of grant monies on behalf of another entity.

The Minnesota Historical Society did not have a current contract for services related to its outsourced payroll and human resources service provider; the society also had not reviewed this service provider's most recent internal control audit.

Finding 3

The society did not have a current, written contract with the service provider it used for certain payroll and other human resources functions. The most recent contract with the service provider had been executed in approximately 2000, 12 years ago. Without bidding or renegotiating that contract, the two parties mutually agreed to annual price increases provided by the vendor. Without a current, written contract, it may be difficult to resolve misunderstandings or disputes about the roles and responsibilities of each party to the agreement. In addition, because the society has not rebid the contract, it may be overpaying for these types of services or not getting the best available terms. The society paid the service provider about \$60,000 in fiscal years 2010 and 2011, respectively.

Since the society had not reviewed the service provider's independent audit of its internal controls, it was unaware if there were any reported deficiencies. Service organization audits provide valuable information that users of the service need to assess and address the risks associated with an outsourced service. The report generally includes internal controls required by the user organization to ensure the objectives of the control are achieved.¹¹ We obtained the service provider's report and confirmed it concluded that the payroll service provider's internal controls were adequate. We also determined that, although the society had not reviewed the report, the society had internal controls in place to address the identified risks.

Recommendations

- *The society should have a current, written contract with its payroll and human resources service provider.*
- *The society should consider rebidding its contract for payroll and human resources functions.*
- *The society should obtain and review the payroll service provider's internal control report to ensure the provider has adequate internal controls and the society has implemented the user organization controls identified in the report.*

¹¹ Service organization control reports are prepared by independent auditors retained by the service organization. The auditors conduct their examinations in accordance with the American Institute of Certified Public Accountants' Statement on Standards for Attestation Engagements Number 16, *Reporting on Controls at a Service Organization*.

September 28, 2012

James R. Nobles, Legislative Auditor
Office of the Legislative Auditor
State of Minnesota
Room 140 Centennial Building
658 Cedar Street
St. Paul, MN 55155-1603

Dear Mr. Nobles:

Please extend our thanks to the staff in the Legislative Auditor's Office for the thorough and professional review of our work at the Minnesota Historical Society, especially in relation to the Minnesota Historical and Cultural Heritage Grants Program funded through the Legacy Amendment. We appreciate the work of the Legislative Auditor's Office and have already taken steps to remedy many of the findings. Our actions are outlined below.

When the Legacy Amendment was passed in 2008, the Minnesota Historical Society moved expediently and thoroughly to make available the Historical and Cultural Heritage Grants Program. We based the creation of this new, significant program on the smaller and highly effective grants programs we've operated at MHS since 1969. To date, Historical and Cultural Heritage Grants have been made in every Minnesota County, and as a result, have greatly enhanced the cultural heritage of communities throughout the state.

In administering this program, we have taken seriously the legislature's desire that Legacy funds be spent in a transparent and accountable manner. The timeliness of the Legislative Auditor's report has given us the opportunity to refine our procedures drawing upon the many years of experience we have in operating grants programs.

Following are the responses to the specific findings presented in the report:

Finding # 1

Some Minnesota Historical Society grants did not comply with all of the society's grant policies.

- Point 1 Include language requiring compliance with Minnesota Statutes 16B.98 in grant agreements.

MHS Response: Completed. Beginning June 2012, MHS has included required language in all grant agreements.

- Point 2 Obtain audited financial statements for grants exceeding \$50,000.

MHS Response: While there is an internal MHS policy, there is no state requirement. MHS will review its internal policy and align it accordingly.

- Point 3 Ensure that grant recipients do not begin work until the agreement is fully executed.

MHS Response: We will clarify our policy regarding the grant period and ensure that consistent language is included in the manuals, guidelines, and all grant agreements.

- Point 4 Ensure peer review is conducted according to policy.

MHS Response: Our policy states we will conduct a peer review of grants in excess of \$50,000; our practice has been to conduct a peer review of grants in excess of \$100,000. We plan to revise our policy to be consistent with the practice. It is important to note that Minnesota Office of Grants Management Policies do not require a peer review.

- Point 5 Submit reports for fiscal agent activities to the governing board and Legislature according to MHS internal policy.

MHS Response: We intend to update our policy to reflect the current reporting schedule which we believe is adequate.

Person Responsible: Peggy Ingison, CFO
Expected Completion: June 30, 2013

Finding # 2

The Minnesota Historical Society did not have documentation to show how it considered technical criteria when awarding some contracts to vendors.

MHS Response: Our practice has been to distinguish between *construction contracts* and *professional technical contracts* as to the type of evaluation of vendor proposals that is required and maintained. MHS project managers had assumed selecting the lowest *qualified* bidder on *construction projects* did not require further documentation. We do maintain documentation of the evaluation of vendor proposals for all professional technical contracts and any construction contracts where the lowest price bidder is not recommended. We will clarify our policies and provide training to staff involved.

Person Responsible: Peggy Ingison, CFO

Expected Completion: June 30, 2013

Finding # 3

The Minnesota Historical Society did not have an updated contract for services related to its outsourced payroll and human resources systems provider. The Society had also not reviewed this provider's most recent systems audit.

MHS Response: The Society outsources its payroll services under an agreement executed several years ago, with an annual pricing update. These pricing updates along with the original agreement constitute the agreement within which payroll and human resources services are provided. While we believe we continue to receive good value for the services, we agree with the recommendation to strengthen the relationship with an updated contract. Further, we intend to embark on a payroll/HR system upgrade in the next couple of years, and we will consider the recommendation to rebid the contract for service. In addition, we will obtain and review the provider's internal control report.

Person Responsible: Peggy Ingison, CFO
Expected Completion: June 30, 2013

Again, we thank the Legislative Auditor's Office for the professional review and the opportunity to strengthen our processes and procedures to ensure accountability for the funds that have enhanced our cultural heritage throughout the State.

Sincerely,



D. Stephen Elliott
Director and CEO