



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

FINANCIAL AUDIT DIVISION REPORT

Minnesota Historical Society

**Arts and Cultural Heritage
Fund Expenditures**

**Internal Controls and
Compliance Audit**

July 2012 through February 2015

September 1, 2015

Report 15-12

FINANCIAL AUDIT DIVISION

Centennial Building – Suite 140

658 Cedar Street – Saint Paul, MN 55155

Telephone: 651-296-4708 • Fax: 651-296-4712

E-mail: auditor@state.mn.us • Website: <http://www.auditor.leg.state.mn.us>

Through Minnesota Relay: 1-800-627-3529 or 7-1-1

Financial Audit Division

The Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division has a staff of forty auditors, most of whom are CPAs. The division conducts audits in accordance with standards established by the American Institute of Certified Public Accountants and the Comptroller General of the United States.

The Office of the Legislative Auditor (OLA) also has a Program Evaluation Division, which evaluates topics periodically selected by the Legislative Audit Commission.

Reports issued by both OLA divisions are solely the responsibility of OLA and may not reflect the views of the Legislative Audit Commission, its individual members, or other members of the Minnesota Legislature. For more information about OLA reports, go to:

<http://www.auditor.leg.state.mn.us>

To obtain reports in electronic ASCII text, Braille, large print, or audio, call 651-296-4708. People with hearing or speech disabilities may call through Minnesota Relay by dialing 7-1-1 or 1-800-627-3529.

To offer comments about our work or suggest an audit, investigation, or evaluation, call 651-296-4708 or e-mail legislative.auditor@state.mn.us.

Conclusion on Internal Controls

The Financial Audit Division bases its conclusion about an organization's internal controls on the number and nature of the control weaknesses we found in the audit. The three possible conclusions are as follows:

Conclusion	Characteristics
Adequate	The organization designed and implemented internal controls that effectively managed the risks related to its financial operations.
Generally Adequate	With some exceptions, the organization designed and implemented internal controls that effectively managed the risks related to its financial operations.
Not Adequate	The organization had significant weaknesses in the design and/or implementation of its internal controls and, as a result, the organization was unable to effectively manage the risks related to its financial operations.



OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

September 1, 2015

Representative Sondra Erickson, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

William R. Stoeri, Board President
Minnesota Historical Society

Members of the Minnesota Historical Society Board of Directors

D. Stephen Elliott, Director
Minnesota Historical Society

This report presents the results of our internal controls and compliance audit of the Minnesota Historical Society's expenditures from the Arts and Cultural Heritage Fund for the period from July 1, 2012, through February 28, 2015. The objectives of this audit were to determine if the society had adequate internal controls for its grant expenditures and complied with finance-related legal requirements.

We discussed the results of the audit with the society's staff at an exit conference on August 11, 2015. This audit was conducted by Brad White, CPA, CISA, CFE (Audit Director), Tracy Gebhard, CPA (Auditor-in-Charge), and assisted by auditors Cassie Harlin, CPA, Lori Leysen, and Natalie Mehlhorn.

We received the full cooperation of the society's staff while performing this audit.

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

Table of Contents

	<u>Page</u>
Report Summary	1
Background	3
Audit Objective, Scope, and Methodology	7
Audit Criteria	7
Conclusion	11
Findings and Recommendations	13
1. The Minnesota Historical Society did not sufficiently monitor how Civics Education Grant recipients used the Arts and Cultural Heritage grant money they received from the society	13
2. The Minnesota Historical Society used a methodology for allocating indirect administrative costs to the Arts and Cultural Heritage Fund that did not comply with the requirement that all costs allocated to the fund must be “directly related to and necessary for” specific projects or activities listed in the appropriation law	15
Minnesota Historical Society Response	19

Report Summary

Background

The Office of the Legislative Auditor conducted this audit to determine whether the Minnesota Historical Society had adequate internal controls over its grant programs and complied with applicable legal requirements when spending money from the Arts and Cultural Heritage Fund. We audited the society's expenditures from the Arts and Cultural Heritage Fund from July 1, 2012, through February 28, 2015.

The Arts and Cultural Heritage Fund is one of the four funds created when voters approved the "Legacy Amendment" to the Minnesota Constitution in 2008. The amendment increased the state's sales tax by three-eighths of 1 percent for 25 years and dedicated 19.75 percent of the additional revenue to the Arts and Cultural Heritage Fund.

For fiscal years 2013, 2014, and 2015, the Legislature appropriated over \$40 million from the Arts and Cultural Heritage Fund to the Minnesota Historical Society. As of February 28, 2015, the society had spent about \$35.3 million from these appropriations (\$13.7 million in Historic and Cultural Grants and Civics Education Grants to other organizations and \$21.6 million for various other programs, exhibits, and other expenses).

Conclusion

For its Historic and Cultural Grant expenditures, the Minnesota Historical Society had adequate internal controls and complied with applicable legal requirements. While the society effectively monitored its Historic and Cultural Grants, it did not sufficiently monitor the recipient's use of Civics Education Grant money. For the nongrant Arts and Cultural Heritage Fund expenditures we tested, the society generally complied with applicable legal requirements. However, the society did not ensure that its cost allocation methodology for indirect administrative costs complied with the Arts and Cultural Heritage Fund appropriation laws.

The society resolved a prior audit finding related to compliance with its internal Historic and Cultural Grant manual.¹

¹ Office of the Legislative Auditor's Financial Audit Division Report 12-20, *Minnesota Historical Society*, Finding 1, issued October 4, 2012.

Findings

- The Minnesota Historical Society did not sufficiently monitor how Civics Education Grant recipients used the Arts and Cultural Heritage grant money they received from the society. ([Finding 1, page 13](#))
 - The Minnesota Historical Society used a methodology for allocating indirect administrative costs to the Arts and Cultural Heritage Fund that did not comply with the requirement that all costs allocated to the fund must be “directly related to and necessary for” specific projects or activities listed in its appropriation law. ([Finding 2, page 15](#))
-

Background

Arts and Cultural Heritage Fund

In 2008, Minnesota voters approved a constitutional amendment, 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 and required specific percentages of the new revenue to be deposited into four separate Legacy funds.² In this report, we refer to this additional sales tax revenue as “Legacy money.”

One of the Legacy funds is the Arts and Cultural Heritage Fund, which receives 19.75 percent of the additional sales tax revenue. The constitutional amendment says that money from this fund must be used for arts, arts education, arts access, and the preservation of Minnesota’s history and cultural heritage.³ The Legislature appropriates money from the Arts and Cultural Heritage Fund to certain state agencies (such as the Minnesota Arts Board) and quasi-state agencies (such as the Minnesota Historical Society) for programs and activities authorized by the Legacy Amendment.

These agencies often grant a significant share of the money they receive to other organizations, particularly nonprofit organizations. Some grants are awarded based on a competitive process; others are awarded because the grant recipient is named by the Legislature in the appropriation law (these are sometimes called “pass through grants”).

This audit focused on the Minnesota Historical Society’s use of the money the Legislature appropriated from the Arts and Cultural Heritage Fund.⁴

Table 1 summarizes the Arts and Cultural Heritage Fund appropriations to agencies in fiscal years 2013, 2014, and 2015.

² The four Legacy funds and their share of the new sale tax revenue are as follows: Outdoor Heritage Fund, 33 percent; Clean Water Fund, 33 percent; Parks and Trails Fund, 14.25 percent; and the Arts and Cultural Heritage Fund, 19.75 percent.

³ The Legacy Amendment also defines the purposes and activities for which money from the other Legacy funds may be used.

⁴ Currently, the Office of the Legislative Auditor is also auditing Arts and Cultural Heritage Fund appropriations made to the Arts Board and the Department of Administration.

Table 1
Arts & Cultural Heritage Fund Appropriations
Fiscal Years 2013, 2014, and 2015

<u>Governmental Entities</u>	<u>FY 2013</u>	<u>FY 2014</u>	<u>FY 2015</u>	<u>Total</u>
Arts Board	\$23,314,000	\$26,675,000	\$27,425,000	\$77,414,000
MN Historical Society	12,150,000	13,800,000	14,075,000	40,025,000
Department of Administration	8,830,000	9,605,000	17,850,000	36,285,000
Department of Education	3,000,000	3,000,000	3,000,000	9,000,000
Humanities Commission	1,575,000	1,725,000	1,750,000	5,050,000
Zoological Board	1,500,000	1,750,000	1,750,000	5,000,000
Indian Affairs Council	875,000	950,000	950,000	2,775,000
Centers for Arts Education	850,000	795,000	750,000	2,395,000
Department of Agriculture	1,400,000	0	0	1,400,000
Legislature	<u>35,000</u>	<u>9,000</u>	<u>9,000</u>	<u>53,000</u>
Total	<u>\$53,529,000</u>	<u>\$58,309,000</u>	<u>\$67,559,000</u>	<u>\$179,397,000</u>

Source: *Laws of Minnesota* 2011, First Special Session, chapter 6, art. 4; *Laws of Minnesota* 2012, chapter 264, art. 5; and *Laws of Minnesota* 2013, chapter 137, art. 4.

Minnesota Historical Society

The Minnesota Historical Society is a nonprofit organization with close connections to the State of Minnesota. Because of those connections, the functions it performs, and the fact that it receives a significant amount of money from the state, it is often referred to as a “quasi-state agency.” In addition, by law, the society is subject to audit by the Office of the Legislative Auditor.⁵

A board of private individuals governs the society and appoints the society’s executive director. In March 2011, the board appointed D. Stephen Elliott as the director.

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 and is home to the Minnesota Historical Society’s library and archives.

In the past three fiscal years, the Legislature appropriated over \$40 million from the Arts and Cultural Heritage Fund to the Minnesota Historical Society. From that amount, as of February 28, 2015, the society had spent about \$35.3 million on the activities listed in Table 2.

⁵ *Minnesota Statutes* 2014, 3.971, subd. 6.

Table 2
Minnesota Historical Society - Arts and Cultural Heritage Fund
Expenditures by Appropriation Activity
July 2012 through February 2015

<u>Activity</u>	<u>FY 2013</u>	<u>FY 2014</u>	<u>FY 2015</u>	<u>Total</u>
Grant Activity:				
Historical and Cultural Heritage Grants	\$ 4,761,901	\$5,055,462	\$3,689,674	\$13,507,038
Civics Education Grants	0	125,000	56,000	181,000
Nongrant Activities:				
Programs and Exhibits	6,992,350	5,413,846	3,380,238	15,786,435
Partnerships	1,444,878	1,667,809	1,143,520	4,256,207
Digital Library	250,000	300,000	300,000	850,000
Archeological and Historic Site Surveys	291,281	281,362	63,533	636,176
Civil War Commemoration	<u>43,389</u>	<u>56,611</u>	<u>10,220</u>	<u>110,220</u>
Total Expenditures	<u>\$13,783,798</u>	<u>\$12,900,091</u>	<u>\$8,643,187</u>	<u>\$35,327,076</u>

Source: Minnesota Historical Society's accounting system.

Within appropriation law, the Legislature identifies the purpose of each activity listed in Table 2 above. The following provides a description of each appropriated activity:

Grant Activities

- Historical and Cultural Heritage Grants – Using a competitive grant process, the society awards money to local, county, regional, or other historic or cultural organizations. The grant recipient must use the money for history programs or projects, or activities to preserve historic and cultural resources. For example, recipients could use grant money to preserve historic properties, conduct oral histories, or archive documents.
- Civics Education Grants – The society provides grants to Learning Law and Democracy Foundation, Kids Voting, St. Paul, and YMCA Youth in Government for the civic and cultural development of Minnesota youth.

Nongrant Activities

- Programs and Exhibits – The society conducts programs and exhibits, such as ‘We Are Hmong’ and ‘Then, Now, Wow,’ for purposes related to the historic and cultural heritage of Minnesota.
- Partnerships – The society collaborates with other entities, such as the University of Minnesota, to conduct activities, like a fellowship program,

which introduces high school students throughout the state to Minnesota's historic and cultural heritage.

- **Digital Library** – In conjunction with the Minitex interlibrary loan system, the society uses these funds to preserve, digitize, and preserve Minnesota images, documents, and historical materials.
- **Archaeological and Historic Site Surveys** – The society uses this money to conduct statewide surveys of Minnesota sites of historical, archaeological, and cultural significance. For example, money was used to survey Indian burial mounds in Northern Minnesota. An oversight board with representatives from the society, Office of the State Archaeologist, and Indian Affairs Council awards these contracts on a competitive basis.
- **Civil War Commemoration** – This appropriation provides funds to the Civil War Task Force for activities that commemorate the sesquicentennial of the American Civil War and the Dakota Conflict.

To conduct these activities, the society used society staff, purchased products and materials from vendors, and contracted with other organizations for services. Table 3 summarizes how the society used its fiscal years 2013, 2014, and 2015 appropriations from the Arts and Cultural Heritage Fund.

Table 3
Minnesota Historical Society - Arts and Cultural Heritage Fund
Expenditures by Type
July 1, 2012, through February 28, 2015

<u>Expenditure Type</u>	<u>FY 2013</u>	<u>FY 2014</u>	<u>FY 2015</u>	<u>Total</u>
Grants	\$ 4,746,143	\$ 5,093,832	\$3,707,559	\$13,547,534
Payroll	4,491,531	4,044,953	2,829,007	11,365,491
Professional and Technical Services	1,600,021	1,500,922	965,930	4,066,873
Other Purchased Services	1,459,482	620,259	144,854	2,224,595
Indirect Costs	271,726	364,199	425,102	1,061,027
Supplies and Equipment	286,157	190,446	29,470	506,074
Other Expenditures	<u>928,738</u>	<u>1,085,479</u>	<u>541,264</u>	<u>2,555,481</u>
Total Expenditures	<u>\$13,783,798</u>	<u>\$12,900,091</u>	<u>\$8,643,187</u>	<u>\$35,327,076</u>

Source: Minnesota Historical Society's accounting system.

Audit Objective, Scope, and Methodology

Our objective for this audit was to answer the following questions:

- Did the society have adequate internal controls over its use of money from the Arts and Cultural Heritage Fund?
- Did the society comply with significant finance-related legal requirements related to its use of money from the Arts and Cultural Heritage Fund?
- Did the society resolve selected prior audit findings?⁶

Our audit scope comprised Arts and Cultural Heritage Fund expenditures made by the Minnesota Historical Society for the period July 1, 2012, through February 28, 2015.

To meet our audit objective, we employed the following methodology: We gained an understanding of the society's financial policies and procedures. We considered the risk of errors in the accounting records and noncompliance with relevant legal requirements. We obtained and analyzed the accounting data to identify unusual trends or significant changes in financial operations. In addition, we selected financial transactions and reviewed supporting documentation to determine whether the society's controls over grant expenditures were effective. We also tested whether grant and other expenditures complied with applicable legal criteria.

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.

Audit Criteria

We assessed the Minnesota Historical Society's internal controls against the most recent edition of the internal control standards published by the U.S. Government Accountability Office.⁷ Specifically for internal controls over grants, we assessed the society against its own grant-related policies and procedures. In the absence of society policies and procedures, we used, as guidance, the policies and procedures established for executive branch state agencies by the Office of Grants Management in the Minnesota Department of Administration.⁸

⁶ Office of the Legislative Auditor, Financial Audit Division Report 12-20, *Minnesota Historical Society*, issued October 4, 2012, Finding 1.

⁷ Comptroller General of the United States, Government Accountability Office, *Standards for Internal Control in the Federal Government*, (Washington D.C., September 2014).

⁸ *Minnesota Statutes* 2014, 16B.97, required the commissioner of Administration to "...create general grants management policies and procedures that are applicable to all executive agencies."

To establish legal compliance criteria for the grants and other expenditures we tested, we examined the requirements in the following documents:

- *Minnesota Constitution*, art. XI, sec.15;
- *Laws of Minnesota* 2011, First Special Session, chapter 6, art. 4, sec. 2, subd. 5;
- *Laws of Minnesota* 2012, chapter 264, art. 5, sec. 4, subd. 5;
- *Laws of Minnesota* 2013, chapter 137, art. 4, sec. 2, subd. 5;
- *Minnesota Statutes* 2014, 129D.17; and
- Minnesota Historical Society Policies and Procedures, including its Historical and Cultural Heritage Grants Manual and grant agreements.

Some of the legal requirements in these documents apply generally to the use of money from any Legacy fund, and others apply specifically to the money appropriated to the Minnesota Historical Society from the Arts and Cultural Heritage Fund in fiscal years 2013, 2014, and 2015.

The following two requirements have been controversial and subject to conflicting interpretations:⁹

Directly Related To And Necessary For. Legislators and groups that supported approval of the Legacy Amendment have worked to limit the use of Legacy funds for administrative costs. Initially, the Legislature placed percentage caps on how Legacy money could be spent on administrative costs. In 2011, the Legislature changed that approach in favor of requiring that Legacy money could be used only for costs that were “directly related to and necessary for” a legislatively authorized Legacy project or activity.

Some recipients of Legacy money have struggled with how to interpret and implement this language, particularly as it applies to those administrative costs that are often referred to as “overhead” or “indirect costs.” Because these are the costs that an organization incurs as part of its general operations, it is more difficult to show that they were directly related to a specific project or activity. These costs include, for example:

- Building costs (e. g., rent/lease, utilities, insurance, maintenance, and security)
- Staff support costs (e.g., human resources, information technology, and general office equipment and supplies)
- Management support costs (e.g., executive staff, legal services, accounting, financial reporting, and public relations)

⁹ For a more extended discussion of these two legal requirements, see Office of the Legislative Auditor, Program Evaluation Division, *The Legacy Amendment*, November 2011, pages 45-58.

In a 2011 report, we acknowledged that it might be difficult for organizations to show how “indirect costs” meet the “directly related to and necessary for” test. But we also emphasized that agencies could not ignore this legal requirement. We said:

We understand that justifying the use of Legacy money at a detailed level will require staff time and involve costs. But, in our view, that greater level of effort and documentation is what the law requires. Organizations that receive Legacy money must be able to show that all cost—including [all] administrative costs—charged to a Legacy appropriation are “directly related to and necessary for” the specific appropriation they received.¹⁰

We applied this expectation to the Minnesota Historical Society in this audit because the “directly related to and necessary for” requirement was stated in the laws that appropriated money from the Arts and Cultural Heritage Fund to the society. For example, the appropriation law enacted in 2011 said:

Money appropriated in this article may not be spent on activities unless they are directly related to and necessary for a specific appropriation. Money appropriated in this article must not be spent on indirect costs or other institutional overhead charges that are not directly related to and necessary for a specific appropriation.¹¹

In applying this legal requirement to the Minnesota Historical Society, we followed *Minnesota Statutes* 2014, 645.16, which provides guidance on interpreting and applying state law. It says in part:

The object of all interpretation and construction of laws is to ascertain and effectuate the intention of the legislature. Every law shall be construed, if possible, to give effect to all its provisions. When the words of a law in their application to an existing situation are clear and free from all ambiguity, the letter of the law shall not be disregarded under the pretext of pursuing the spirit.¹²

We believe the language of this law is clear and “the letter of the law” must be applied. Therefore, we expected the Historical Society to demonstrate that it used the money it received in fiscal years 2013, 2014, and 2015 from the Arts and Cultural Heritage Fund only to pay for costs that were “directly related to and necessary for” the programs and activities listed in the law that appropriated money from the fund to the society.

¹⁰ Office of the Legislative Auditor, Program Evaluation Division, *The Legacy Amendment*, November 2011, page 57.

¹¹ *Laws of Minnesota* 2011, First Special Session, chapter 6, art. 4, sec. 2, subd. 2.

¹² *Minnesota Statutes* 2014, 645.16.

Supplement Not Substitute. In addition to demonstrating that it has complied with the “directly related to and necessary for” requirement, recipients of Legacy money must also show that they have complied with a requirement that is in the Legacy Amendment itself. That requirement says that the money raised by the Legacy Amendment’s sales tax increase “must [be used to] supplement traditional sources of funding...and may not be used as a substitute.”¹³

To emphasize the importance of this requirement, the Legislature has frequently repeated it in the laws that appropriated money from the four Legacy funds. It did that in the laws that appropriated money from the Arts and Cultural Heritage Fund to the Minnesota Historical Society. For example, the 2011 appropriation law said:

Funds directly appropriated to the Minnesota Historical Society shall be use to supplement, and not substitute for, traditional sources of funding.

Grant agreements entered into by the Minnesota Historical Society and other recipients of appropriations in this subdivision shall ensure that these funds are used to supplement and not substitute for traditional sources of funding.¹⁴

Unfortunately, the meaning of the “supplement not substitute” requirement is uncertain. Neither the Legacy Amendment nor a subsequent statutory provision has defined what constitutes “traditional sources of funding.”¹⁵ A key question that has not been answered is: How many years must an expense be funded from a particular revenue source for that source to be considered “traditional”?

In addition, agencies often argue that they are “forced” to use Legacy money to maintain certain programs and activities or pay for indirect or overhead costs because the Legislature has reduced or eliminated a “traditional” source of funding for those programs and activities.

Both of these factors make it difficult for agencies to comply and difficult for OLA to judge whether agencies complied with the “supplement not substitute” requirement. Nevertheless, to the extent possible, we applied the requirement during this audit, as we have and will in other audits that involve Legacy money.

¹³ *Minnesota Constitution*, art. XI, sec. 15.

¹⁴ *Laws of Minnesota* 2011, First Special Session, chapter 6, art. 4, sec. 2, subd. 5.

¹⁵ We discussed the uncertainty over the meaning of the Legacy Amendment’s “supplement not substitute” requirement in our report, Office of the Legislative Auditor, Program Evaluation Division, *The Legacy Amendment*, November 2011, pages 45-53.

Conclusion

For its Historic and Cultural Grant expenditures, the Minnesota Historical Society had adequate internal controls and complied with applicable legal requirements. While the society effectively monitored its Historic and Cultural Grants, it did not sufficiently monitor the recipient's use of Civics Education Grant money. For the nongrant Arts and Cultural Heritage Fund expenditures we tested, the society generally complied with applicable legal requirements. However, the society did not ensure that its cost allocation methodology for indirect administrative costs complied with the Arts and Cultural Heritage Fund appropriation laws.

The society resolved a prior audit finding related to compliance with its internal Historic and Cultural Grant manual.¹⁶

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

¹⁶ Office of the Legislative Auditor's Financial Audit Division Report 12-20, [Minnesota Historical Society](#), Finding 1, issued October 4, 2012.

Findings and Recommendations

The Minnesota Historical Society did not sufficiently monitor how Civics Education Grant recipients used the Arts and Cultural Heritage grant money they received from the society.

Finding 1

In the 2013 law that appropriated Legacy money to the Minnesota Historical Society for fiscal years 2014 and 2015, the Legislature required the society to award Civic Education Grants to three nonprofit organizations: Learning Law and Democracy Foundation, Kids Voting St. Paul, and YMCA Youth in Government.¹⁷ According to the appropriation law, the grants were for these organizations “to conduct civics education programs for the civic and cultural development of Minnesota youth.” The law defined “civic education” as follows:

Civic education is the study of constitutional principles and the democratic foundation of our national, state, and local institutions and the study of political processes and structures of government, grounded in the understanding of constitutional government under the rule of law.¹⁸

The Legislature appropriated \$125,000 in each fiscal year (\$250,000 total) from the Arts and Cultural Heritage Fund to the society for the grants.¹⁹ As of March 12, 2015, the society had awarded a total of \$180,000.²⁰

We identified the following internal control weaknesses in the way the society administered grants:

- The society advanced money to the three grant recipients without establishing adequate internal controls. For example, when a state agency advances money, the Office of Grants Management requires the agency to be confident that the grantee will be able to account for the grant money and abide by the terms of the grant agreement by reviewing the grant recipient’s financial statements, document justification, and reconcile grants over \$50,000.²¹ The society did not review the grant recipient’s financial statements, document justification for advanced payment, or reconcile grants over \$50,000. Advancing grant money without adequate

¹⁷ Laws of Minnesota 2013, chapter 137, art. 4, sec. 2, subd. 5(c).

¹⁸ *Laws of Minnesota* 2013, chapter 137, art. 4, sec. 2, subd. 5.

¹⁹ *Laws of Minnesota* 2013, chapter 137, art. 4, sec. 2, subd. 5.

²⁰ The society withheld a total of \$70,000 in fiscal year 2015 grant money from Kids Voting St. Paul and YMCA Youth in Government because they failed to submit their final narrative and financial reports to the society.

²¹ Department of Administration, Office of Grants Management, Operating Policy and Procedure Number: 08-08, *Policy on Grant Payments*.

controls increases risk that a grant recipient could misuse grant money without detection.

- In its grant agreement with the Civics Education Grant recipients, the society required each grant recipient to submit an annual final narrative and financial report, before it awards additional grant money. The reports indicate to the society how the grant recipient had spent the grant money. The society did not review and approve the final narrative and financial report for two of the grant recipients. For example, when state agencies receive grant recipient reports, the Office of Grants Management policy requires agencies to review the reports.²² Without reviewing the final narrative and financial report, the society is not able to determine if the grant recipient used the grant funds appropriately.

Society officials told us that they believed the society had less authority and less responsibility to monitor the Civics Education Grants because the Legislature specifically named the grant recipient in law; the grant recipient was not selected by the society through a competitive process. The society is not alone in taking this position.

In a 2007 review of state grants to nonprofits, OLA 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.”²³ Although some agencies said they monitor all grant recipients the same, some agencies said they had little leverage with legislatively selected grant recipients and recalled being criticized by legislators when they did try to impose controls.

Since our 2007 report, OLA has consistently argued against the Legislature naming grant recipients in law, but that has not stopped the practice. We have also consistently argued for strong controls over all grant recipients, including those named in law by the Legislature. Our position is supported by the state’s Office of Grants Management, which has a policy that says:

It is the policy of the State of Minnesota to manage legislatively mandated grants with the same level of oversight applied to other state grants, while respecting and maintaining the legislative intent. Legislatively made grants shall be monitored using the same standards applied to other types of state grants....²⁴

²² Department of Administration, Office of Grants Management, Operating Policy and Procedure Number: 08-09, *Policy on Grant Progress Reports*.

²³ Office of the Legislative Auditor, Program Evaluation Division, *State Grants to Nonprofit Organizations*, January 2007, pages 37-38.

²⁴ Department of Administration, Office of Grants Management, Operating Policy and Procedure Number: 08-11, *Policy on Legislatively Mandated Grants*.

Because of its status as a private nonprofit organization, the Minnesota Historical Society could argue that it is not required to follow the policies of the state's Office of Grants Management. However, given its connections to the state and the amount of money it receives from the state, the Historical Society is effectively a "quasi-state agency." Moreover, the Office of Grants Management policies are based on good management practices, and we believe the society should follow them—or comparable policies—when it administers a state grant, including when the grant recipient is named in law by the Legislature.

Because we found internal control weaknesses in the way the Historical Society administered the Civics Education Grants, we expanded our testing to better assess how those grant recipients used the grant money they received. We performed the following additional procedures for each of the three Civics Education Grant recipients:

- We obtained and reviewed the grant recipient's financial reports. These reports identified the individual expenditure transactions that the grant recipient paid for with grant money.
- We conducted site visits to discuss with the grant recipient the activities conducted and the expenses paid for with grant money.
- We performed a financial reconciliation for a sample of expenditure transactions. For those expenditure transactions, we reviewed bank statements, invoices, receipts, and proof of purchase.

We found that expenditures were appropriate and complied with the appropriation law. However, without adequate monitoring controls, the society increases its risk that grant recipients may misuse grant money.

Recommendation

- *The Minnesota Historical Society should develop and implement adequate internal controls for monitoring grant award advances and reporting use of grant funds by recipients specifically named by the Legislature in appropriation law.*

The Minnesota Historical Society used a methodology for allocating indirect administrative costs to the Arts and Cultural Heritage Fund that did not comply with the requirement that all costs allocated to the fund must be "directly related to and necessary for" specific projects or activities listed in the appropriation law.

Finding 2

In conducting its operations, the Minnesota Historical Society incurred a variety of direct and indirect administrative costs, such as salaries and benefits, office supplies and equipment, lease and rent payments, and insurance. The society

properly charged some of these administrative costs directly to the appropriation it received from the Arts and Cultural Heritage Fund in the years covered by our audit. For example, the society used money from the appropriations for salaries and various services and materials they determined were directly related to certain exhibits, such as “We Are Hmong.”

In addition, the society charged a share of its general administrative costs—“indirect” or “overhead” costs—to its appropriation from the Arts and Cultural Heritage Fund. As we discussed in the Audit Criteria section of this report, we believe the law that appropriated money from the Arts and Cultural Heritage Fund to the society requires the society to demonstrate that these indirect or overhead costs were “directly related to and necessary for” the projects and activities listed in the appropriations law.

We believe the society did not comply with the “directly related to and necessary for” requirement for the following reasons:

- The society did not analyze individual costs to ensure they were specifically related to the projects and activities the Legislature authorized in the law that appropriated money from the fund to the society.
- The society selected arbitrary percentages and multiplied them against the salary costs it allocated directly to the projects and programs it supported with the money it received from the Arts and Cultural Heritage Fund. As shown on Table 4, in fiscal year 2013, it used 8 percent; in fiscal year 2014, it used 12 percent; and, in 2015, it used 20 percent which resulted in indirect costs ranging from 2 to 4.5 percent of the appropriation funding provided to the society. Society management told us they selected these percentages in order to, over several years, increase the total indirect cost it charges to the Arts and Cultural Heritage Fund until it reaches the percentage it uses to charge its federal funds. In fiscal year 2016, that would be 38.72 percent of direct salaries.

Table 4 shows the indirect costs charged to the Arts and Cultural Heritage Fund.

Table 4
Minnesota Historical Society - Arts and Cultural Heritage Fund
Indirect Costs
July 1, 2012, through February 28, 2015

	<u>FY 2013</u>	<u>FY 2014</u>	<u>FY 2015¹</u>
Direct Salaries	\$3,400,000	\$3,030,000	\$2,126,000
Indirect Cost Percentage Used	8%	12%	20%
Total Indirect Costs	\$272,000	\$363,600	\$425,200
Appropriation	\$12,950,000	\$13,800,000	\$9,400,000
Percentage of Appropriation for Indirect Costs	2.1%	2.6%	4.5%

Source: Minnesota Historical Society's accounting system and *Laws of Minnesota* 2011, First Special Session, chapter 6, art. 4, sec. 2, subd. 5; *Laws of Minnesota* 2012, chapter 264, art. 5, sec. 4, subd. 5; *Laws of Minnesota* 2013, chapter 137, art. 4, sec. 2, subd. 5.

¹ The amounts in fiscal year 2015 represent the salaries through February 28, 2015, and two-thirds of the fiscal year 2015 appropriation to the society.

Society justified this approach by indicating that it is allowed by the guidance provided to state agencies by the Minnesota Department of Management and Budget (MMB). The guidance developed by the Minnesota Department of Management and Budget does give state agencies wide latitude to use Legacy money for administrative costs. For example, the guidance says: “The ‘direct and necessary’ requirement does not prohibit the use of indirect cost billing for necessary administrative costs when that is the most efficient mechanism.” It also tells agencies that they can use federal policy on the allocation of indirect costs as a guide for understanding allowable Legacy Fund expenditures. We think these and other statements in MMB’s guidance may have lead agencies to allocate costs to Legacy appropriations in ways that do not comply with the “directly related to and necessary for” requirement the Minnesota Legislature has enacted into state law and, ultimately, state law must take precedence over MMB guidance. We do not believe the resulting allocation of indirect cost to the Arts and Cultural Heritage Fund complies with the more restrictive “directly related to and necessary for” requirement in state law.

Recommendation

- *The Minnesota Historical Society should implement cost allocation policies and procedures that ensure that money it receives from the Arts and Cultural Heritage Fund is used only for costs that are “directly related to and necessary for” the administration of projects or activities listed in law that appropriated money to the society from the Arts and Cultural Heritage Fund. Alternatively, the society could seek an exemption in law from the “directly related to and necessary for” requirement.*

August 25, 2015

Mr. James Nobles, Legislative Auditor
Office of the Legislative Auditor
Suite 140, Centennial Building
658 Cedar Street
St. Paul, Minnesota 55155

Dear Mr. Nobles:

Thank you for the thorough and professional activities carried out by your staff in its recent visit to the Minnesota Historical Society. We share the Office of the Legislative Auditor's focus on prudent spending of Legacy Amendment / Arts and Cultural Heritage Funds and appreciate the ongoing conversation about how to best administer these funds in light of evolving requirements and interpretations surrounding their use. In particular, we are interested in working with you and the Legislature to find an agreed-upon approach that balances our shared goal of maximizing dollars that support programs, while minimizing administrative dollars/costs that are necessary to administer public funds responsibly.

Overall Philosophy of the Minnesota Historical Society (MNHS) on State Funding and Administrative Costs

MNHS has had a long-standing partnership with the State of Minnesota, with many of our state responsibilities delineated by statute. General Fund state support of MNHS operations has been significant. Given this relationship, it is a natural fit for the Legislature to provide Arts and Cultural Heritage Funds to MNHS for the statewide preservation and enhancement of Minnesota's history and its cultural and historical resources.

MNHS maintains a balance when allocating administrative costs to its various funding sources; we work to ensure that there is maximum benefit to the programs funded with Legacy and other public dollars while recognizing the added demands these programs place on the infrastructure of the organization. Properly allocating administrative costs also ensures that all revenue sources bear their fair share of the infrastructure costs as required by law (MS 16A.127, Subd. 3).

Background and Implementation of Administrative Cost Allocation

Recognizing our responsibility to be accountable to all of the organization's funding sources – state General Fund, private donors, federal funds, and Legacy funds – MNHS has had numerous conversations with legislators, the Office of the Legislative Auditor and Minnesota Management

Mr. James Nobles, Legislative Auditor
August 25, 2015
Page 2

& Budget (MMB) in setting up our administrative cost system. We followed the guidance provided by MMB. That guidance is based on the federal principles of “needed, reasonable, and consistent;” which is very similar to the state legislation requiring Legacy administrative costs to be “directly related to and necessary for.”

MNHS uses a federally approved and audited indirect cost plan under the direction of the National Park Service (Department of the Interior.) In keeping with MMB guidance, MNHS has used the federally approved rate as the basis of the administrative charges to Legacy funds; however, MNHS did not charge the full federal rate to Legacy funds, in order to minimize the administrative costs allocated and charged to the Legacy fund appropriation. In other words, MNHS has charged *less* than MMB and federal approaches would have allowed.

It may be helpful to note that funds are appropriated to MNHS for programs managed directly by MNHS with its own employees. Employees funded directly with Legacy funds account for approximately 18% of the total salary costs for the organization. At the same time, Legacy funds, including the grant payments that go to other organizations, account for approximately 25% of the total operating expenses of the organization. Since the inception of the Legacy appropriations, MNHS has absorbed a significant portion of the administrative costs for the Legacy funds.

Administrative expenses are for infrastructure costs of the organization, such as human resources, information technology, payroll, financial accounting, reporting, and payment processing. Given the context noted above (Legacy funds as 18% of total salaries and 25% of total expenses), these expenses are directly related to (given the proportion of overall activities related to Legacy programs) and necessary for managing responsibly the Legacy grants and programs. We believe that charging a portion of the federally approved overhead rate to Legacy funds is reasonable, just as the State of Minnesota includes an allocation of statewide indirect costs to the four Legacy funds, in keeping with the statute requiring that all state funds pay their fair share of administrative expenses.

As noted in our responses below we look forward to a continued conversation on how to balance these various issues.

Sincerely,

/s/ D. Stephen Elliott

D. Stephen Elliott
Director and Chief Executive Officer

Minnesota Historical Society Comments and Actions on Office of the Legislative Auditor Findings:

Finding # 1:

The Minnesota Historical Society did not sufficiently monitor how Civics Education Grant recipients used the Arts and Cultural Heritage Fund grant money they received from the society.

MNHS Response:

The Minnesota Historical Society agrees that we should clarify and strengthen requirements for legislatively designated grants.

As you observe in the report: "OLA has consistently argued against the Legislature naming grant recipients in law, but that has not stopped the practice." Given that this practice is likely to continue, we will implement improved procedures to strengthen oversight of these appropriations. The Minnesota Office of Grants Management (OGM) guidelines regarding legislatively designated grants contain a good framework for this.

Using OGM guidelines as a framework, we will improve procedures, specifically requiring an upfront submission and review of the organization's budget and work plan before funds are distributed. In the case of multi-year appropriations, we will continue our long-time practice of reviewing narrative and budget information before the second year or subsequent appropriations are released. In addition, we will follow OGM guidelines of financial review of the organization for appropriations above specified dollar thresholds.

Person Responsible: Peggy Ingison, Chief Financial Officer

Date: January 15, 2016

Finding # 2:

The Minnesota Historical Society used a methodology for allocating indirect administrative costs to the Arts and Cultural Heritage Fund that did not comply with the requirement that all costs allocated to the fund must be "directly related to and necessary for" specific projects or activities listed in the appropriation law.

MNHS Response:

While we believe that our indirect cost procedures, which follow MMB and federal guidelines as described above, are reasonable and comply with the "directly related to and necessary for" provision of law, we look forward to further conversations with the Legislature and OLA on how to meet the various requirements in state law. Specifically, MNHS, in consultation with the Legislature, OLA, and MMB, will develop an agreed upon methodology and documentation mechanism to demonstrate how our administrative expenditures are "directly related to and necessary for" carrying out the programs authorized by law.

Person Responsible: Peggy Ingison, Chief Financial Officer

Date: June 1, 2016