



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

**FINANCIAL AUDIT DIVISION REPORT**

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# **Minnesota State Arts Board**

## **Arts and Cultural Heritage Fund Expenditures**

### **Internal Controls and Compliance Audit**

**July 2012 through February 2015**

**November 20, 2015**

**Report 15-14**

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FINANCIAL AUDIT DIVISION  
Centennial Building – Suite 140  
658 Cedar Street – Saint Paul, MN 55155  
Telephone: 651-296-4708 • Fax: 651-296-4712  
E-mail: [legislative.auditor@state.mn.us](mailto:legislative.auditor@state.mn.us)  
Website: <http://www.auditor.leg.state.mn.us>  
Through Minnesota Relay: 1-800-627-3529 or 7-1-1

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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.

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## 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.

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## OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

November 20, 2015

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Legislative Audit Commission

Members of the Legislative Audit Commission

Thomas Moss, Board Chair  
Minnesota State Arts Board

Members of the Minnesota State Arts Board

Sue Gens, Executive Director  
Minnesota State Arts Board

This report presents the results of our internal controls and compliance audit of the Minnesota State Arts Board'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 board had adequate internal controls for its grant expenditures and complied with finance-related legal requirements.

We discussed the results of the audit with the board's staff at an exit conference on October 30, 2015. This audit was conducted by Brad White, CPA, CISA, CFE (Audit Director), Tracy Gebhard, CPA (Audit Director), Lori Leysen, CPA (Audit Supervisor), and assisted by auditors Cassie Harlin, CPA, and Natalie Mehlhorn.

We received the full cooperation of the board'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

The Office of the Legislative Auditor conducted this audit to determine whether the Minnesota State Arts Board 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 board'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 approximately \$77.4 million from the Arts and Cultural Heritage Fund to the Minnesota State Arts Board. As of February 28, 2015, the board had spent over \$71 million from these appropriations.

## Conclusion

For its competitive grants, the Minnesota State Arts Board had generally adequate internal controls and generally complied with applicable legal requirements. However, the board did not follow up on concerns it had about two competitive grant recipients. In addition, the board had several internal control weaknesses in the way it administered noncompetitive grants it was required by law to make to regional arts councils.

For the nongrant Arts and Cultural Heritage Fund expenditures we tested, the board generally complied with applicable legal requirements. However, the board may not have complied with the requirement that money from the Arts and Cultural Heritage Fund not be used to pay for costs traditionally paid for with other revenue sources.

The board partially resolved a prior audit finding related to monitoring grant recipients.<sup>1</sup>

## Audit Findings

- The Minnesota State Arts Board did not establish adequate internal controls to ensure that regional arts councils used \$22 million in grants from the Arts and Cultural Heritage Fund in compliance with legal requirements. This is a repeat finding. ([Finding 1, page 11](#))

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<sup>1</sup> Office of the Legislative Auditor, Financial Audit Division Report 12-19, *Minnesota State Arts Board*, Finding 1 (St. Paul, MN, September 20, 2012).

- The Minnesota State Arts Board used money from the Arts and Cultural Heritage Fund for administrative expenditures that it traditionally paid for with money from other funding sources. We believe this does not comply with the Legacy Amendment's requirement that Legacy money must not be used to substitute for traditional sources of funding. ([Finding 2, page 13](#))
  - The Minnesota State Arts Board did not challenge two grant recipients when it questioned whether costs met grant requirements. Despite the board identifying these questionable costs, it made an additional payment to one of these grant recipients. ([Finding 3, page 15](#))
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## Background

### Arts and Cultural Heritage Fund

In 2008, Minnesota voters approved an amendment to the state constitution commonly referred to as the “Legacy Amendment.” The amendment increased the state sales tax by three-eighths of 1 percent for 25 years and required specific percentages of the new revenue to be deposited into four separate Legacy funds.<sup>2</sup> In this report, we refer to this additional sales tax revenue as “Legacy money.”

One of the funds created by the Legacy Amendment 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.<sup>3</sup> The Legislature appropriates money from the Arts and Cultural Heritage Fund to certain state agencies (such as the Minnesota State 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. Agencies award most grants on a competitive process, which involves an evaluation of grant applications with grants awarded to the highest rated applications. However, the Legislature sometimes designates grant recipients in an appropriation law. While the two processes of granting money is different, the responsibility of the grant-making agency to ensure the proper use of the grant money by the recipient is the same, whether the recipient is selected by the agency or the Legislature.

Table 1 shows the entities that received appropriations from the Arts and Cultural Heritage Fund in fiscal years 2013, 2014, and 2015 and the amounts they received.

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

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

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**Table 1**  
**Arts and 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>
<b>Minnesota State Arts Board</b>	<b>\$23,314,000</b>	<b>\$26,675,000</b>	<b>\$27,425,000</b>	<b>\$77,414,000</b>
Minnesota Historical Society	12,950,000	13,800,000	14,075,000	40,825,000
Department of Administration	8,830,000	9,605,000	8,925,000	27,360,000
Department of Education	3,000,000	3,000,000	3,000,000	9,000,000
Minnesota Zoo	1,500,000	1,750,000	1,750,000	5,000,000
Minnesota Humanities Center	1,575,000	1,725,000	1,750,000	5,050,000
Indian Affairs Council	875,000	950,000	950,000	2,775,000
Perpich Center for Arts Education	850,000	795,000	750,000	2,395,000
Department of Agriculture	1,400,000	0	0	1,400,000
Legislature	35,000	9,000	9,000	53,000
Total	<u>\$54,329,000</u>	<u>\$58,309,000</u>	<u>\$58,634,000</u>	<u>\$171,272,000</u>

Source: *Laws of Minnesota* 2011, First Special Session, chapter 6, art. 4; *Laws of Minnesota* 2012, chapter 264, art. 5; *Laws of Minnesota* 2013, chapter 137, art. 4; *Laws of Minnesota* 2014, chapter 312, art. 4, sec. 2.

This audit focused on money appropriated to the Minnesota State Arts Board.<sup>4</sup>

## Minnesota State Arts Board

The Minnesota State Arts Board is a state agency that “stimulates and encourages the creation, performance, and appreciation of the arts in the state.”<sup>5</sup> The board’s authority and responsibilities are defined in *Minnesota Statutes* 2015, Chapter 129D.

The board consists of eleven citizens appointed by the Governor to serve four-year terms; eight members represent each of the state’s congressional districts, and three members are appointed at large. In 2009, the board named Sue Gens as the board’s executive director.

Table 2 summarizes how the board used its fiscal years 2013, 2014, and 2015 appropriations from the Arts and Cultural Heritage Fund.

<sup>4</sup> The Office of the Legislative Auditor also audited the Arts and Cultural Heritage Fund appropriations made to the Minnesota Historical Society (Report 15-12, issued September 1, 2015) and the Department of Administration (Report 15-15, issued November 20, 2015).

<sup>5</sup> Minnesota State Arts Board website, <http://www.arts.state.mn.us/>.

**Table 2**  
**Minnesota State Arts Board - 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<sup>1</sup></u>	<u>Total</u>
Grants, Aids, and Subsidies	\$22,553,939	\$24,935,496	\$20,981,587	\$68,471,022
Payroll	713,241	876,633	500,182	2,090,055
Purchased Services	112,664	152,798	158,615	424,078
Indirect Costs	28,806	37,332	12,475	78,612
Other Expenses	8,854	18,570	18,457	45,881
Noncapital – Assets	1,788	21,696	1,584	25,068
Supplies and Materials	5,513	13,373	4,247	23,133
Equipment and Capital Leases	0	5,316	3,684	9,001
Repair – Maintenance	0	5,049	2,747	7,796
Total Expenditures	<u>\$23,424,805</u>	<u>\$26,066,262</u>	<u>\$21,683,579</u>	<u>\$71,174,646</u>

<sup>1</sup> The scope of our audit included fiscal year 2015 activity from July 1, 2014, through February 28, 2015.

Source: State of Minnesota's accounting system.

As shown in Table 2, the largest share of the board's expenditures was for grants, aids, and subsidies. The expenditures in this category included the following activities:

- Arts and Arts Access Initiatives. The board made grants to Minnesota artists and arts organizations to (1) create, produce, and present high-quality arts activities; (2) overcome barriers to accessing high-quality arts activities; and (3) instill the arts into the community and public life in Minnesota.
- Arts Education. The board made grants to individuals, organizations, nonprofit schools, and conservatories to implement high quality, age appropriate arts education for Minnesotans of all ages to develop knowledge, skills, and understanding of the arts.
- Arts and Cultural Heritage. The board made grants to individuals and organizations for events and activities that represent the diverse cultural arts traditions, including folk and traditional artists and art organizations.
- Regional Arts Councils. As required by law, the board made grants to the council equal to approximately 30 percent of its appropriation from the Art and Cultural Heritage Fund. The councils re-granted the money to arts organizations and individual artists within their regions.

- Turnaround Arts Initiative. The board transferred money to the Perpich Center and made grants to the state's highest poverty, lowest performing elementary and middle schools for arts education.

Table 3 shows how much the board has spent on the activities listed above as of February 28, 2015.

**Table 3**  
**Minnesota State Arts Board - Arts and Cultural Heritage Fund**  
**Expenditures by Appropriation Activity**  
**July 2012 through February 2015**

<u>Activity</u>	<u>FY2013</u>	<u>FY2014</u>	<u>FY2015<sup>1</sup></u>	<u>Total</u>
Arts and Arts Access Initiatives	\$12,675,391	\$13,714,490	\$ 9,584,245	\$35,974,126
Arts Education	2,365,672	2,505,819	2,501,548	7,373,040
Arts and Cultural Heritage	763,176	1,054,196	1,054,430	2,871,803
Regional Arts Councils	6,749,700	7,642,500	7,642,500	22,034,700
Turnaround Arts Initiative <sup>2</sup>	0	0	198,964	198,964
Total Expenditures	<u>\$22,553,939</u>	<u>\$24,917,006</u>	<u>\$20,981,687</u>	<u>\$68,452,632</u>

<sup>1</sup> The scope of our audit included fiscal year 2015 activity from July 1, 2014, through February 28, 2015.

<sup>2</sup> In addition to the expenditures shown in the table, the board transferred approximately \$445,000 to the Perpich Center for Arts Education.

Source: State of Minnesota's accounting system.

## Audit Objective, Scope, and Methodology

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

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

Our audit scope comprised Arts and Cultural Heritage Fund expenditures made by the Minnesota State Arts Board 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 board'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

<sup>6</sup> Office of the Legislative Auditor, Financial Audit Division Report 12-19, *Minnesota State Arts Board*, Finding 1 (St. Paul, MN, September 20, 2012).

identify unusual trends or significant changes in financial operations. In addition, we selected financial transactions and reviewed supporting documentation to determine whether the board'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 State Arts Board's internal controls against the most recent edition of the internal control standards published by the U.S. Government Accountability Office.<sup>7</sup> Specifically, for internal controls over grants, we assessed the board against its own grant-related policies and procedures and the policies and procedures established by the Office of Grants Management in the Department of Administration.<sup>8</sup>

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 (the "Legacy Amendment");
- *Laws of Minnesota* 2011, First Special Session, chapter 6, art. 4, sec. 2, subd. 3;
- *Laws of Minnesota* 2013, chapter 137, art. 4, sec. 2, subd. 3;
- *Minnesota Statutes* 2014, 129D.17;
- *Office of Grants Management Policies*; and
- *Minnesota State Arts Board Policies and Procedures*.

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 State Arts Board 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:<sup>9</sup>

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

<sup>8</sup> *Minnesota Statutes* 2015, 16B.97, required the commissioner of Administration to "...create general grants management policies and procedures that are applicable to all executive agencies."

<sup>9</sup> For a more extended discussion of these two legal requirements, see Office of the Legislative Auditor, Program Evaluation Division report, *The Legacy Amendment* (St. Paul, MN, November 2011), pages 45-58.

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**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, security)
- Staff support costs (e.g., human resources, information technology, general office equipment and supplies)
- Management support costs (e.g., executive staff, legal services, accounting, financial reporting, public relations)

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. However, 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 costs—including [all] administrative costs—charged to a Legacy appropriation are “directly related to and necessary for” the specific appropriation they received.<sup>10</sup>

We applied this expectation to the Minnesota State Arts Board 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 board. 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

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<sup>10</sup> Office of the Legislative Auditor, Program Evaluation Division report, *The Legacy Amendment* (St. Paul, MN, November 2011), page 57.

are not directly related to and necessary for a specific appropriation.<sup>11</sup>

In applying this legal requirement to the Arts Board, we followed *Minnesota Statutes* 2015, 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.<sup>12</sup>

We believe the language of this law is clear and “the letter of the law” must be applied. Therefore, we expected entities to be able to demonstrate that they used the money 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 board.

**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.”<sup>13</sup>

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 State Arts Board. For example, the 2011 appropriation law said:

Grant agreements entered into by the Minnesota State Arts Board 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.

Appropriations made directly to the Minnesota State Arts Board shall supplement, and shall not substitute for, traditional sources of funding.<sup>14</sup>

Unfortunately, the meaning of the “supplement not substitute” requirement is uncertain. Neither the Legacy Amendment nor a subsequent statutory provision

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

<sup>12</sup> *Minnesota Statutes* 2015, 645.16.

<sup>13</sup> *Minnesota Constitution*, art. XI, sec. 15.

<sup>14</sup> *Laws of Minnesota* 2011, First Special Session, chapter 6, art. 4, sec. 2, subd. 3.

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has defined what constitutes “traditional sources of funding.”<sup>15</sup> 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 are complying with the “supplement not substitute” requirement. Nevertheless, we applied the requirement during this audit, as we have and will in other audits that involve Legacy money.

## Conclusion

For its competitive grants, the Minnesota State Arts Board had generally adequate internal controls and generally complied with applicable legal requirements. However, the board did not follow up on concerns it had about two competitive grant recipients. In addition, the board had several internal control weaknesses in the way it administered noncompetitive grants it was required by law to make to regional arts councils.

For the nongrant Arts and Cultural Heritage Fund expenditures we tested, the board generally complied with applicable legal requirements. However, the board may not have complied with the requirement that money from the Arts and Cultural Heritage Fund not be used to pay for costs traditionally paid for with other revenue sources.

The board partially resolved a prior audit finding related to monitoring grant recipients.<sup>16</sup>

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

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<sup>15</sup> We discussed the uncertainty over the meaning of the Legacy Amendment’s “supplement not substitute” requirement in our 2011 report, Office of the Legislative Auditor, Program Evaluation Division, *The Legacy Amendment* (St. Paul, MN), pages 45-53.

<sup>16</sup> Office of the Legislative Auditor, Financial Audit Division Report 12-19, *Minnesota State Arts Board*, Finding 1 (St. Paul, MN, September 20, 2012).

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# Findings and Recommendations

**The Minnesota State Arts Board did not establish adequate internal controls to ensure that regional arts councils used \$22 million in grants from the Arts and Cultural Heritage Fund in compliance with legal requirements. This is a repeat finding.<sup>17</sup>**

## Finding 1

The 2011 and 2013 appropriation laws required the Minnesota State Arts Board to grant 30 percent of its appropriation from the Arts and Cultural Heritage Fund to regional arts councils.<sup>18</sup> State law defines the councils as “grassroots organizations designed by the board to make final decisions on the use of appropriations for local and regional arts development.”<sup>19</sup> There are 11 councils located throughout Minnesota. Each council is composed of local citizens who review applications and make grants to individual artists and arts organization in their respective region. During our audit scope, the board had awarded approximately \$22 million to the councils.

We have the following concern about the way the board administered grants to the regional arts councils:

The board made quarterly grant payments to the councils without adequate internal controls to ensure that the council used the grant money in compliance with state legal requirements.

According to the state’s grant management policy, reimbursement is the preferred method of making grant payments.<sup>20</sup> However, an agency may make “advance payments” if certain precautions are followed. For example:

- An agency must prepare a written justification that details the specific need to utilize advance payments on a case-by-case basis, and a copy of the signed justification must be maintained in the grant file. The State

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<sup>17</sup> This is a repeat finding from both our 2012 and 2010 audit reports. Office of the Legislative Auditor, Financial Audit Division Report 12-19, *Minnesota State Arts Board*, Finding 1 (St. Paul, MN, September 20, 2012). Office of the Legislative Auditor, Financial Audit Division Report 10-26, *Minnesota State Arts Board*, Finding 2 (St. Paul, MN, August 12, 2010).

<sup>18</sup> In 1977, the Minnesota Legislature established the 11 councils to distribute state appropriations to small arts organizations throughout the state. The board awards 30 percent of the appropriations (arts and arts initiatives, arts education, and arts and cultural heritage) to the councils after it deducts the amount the Legislature allocated for board administrative costs.

<sup>19</sup> *Minnesota Statutes 2015*, 129D.01(e).

<sup>20</sup> Department of Administration, Office of Grants Management, Operating Policy and Procedure Number 08-08, *Policy on Grant Progress Reports*.

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Arts Board did not provide us with this justification for its advances of grant money to the regional arts councils.<sup>21</sup>

- An agency must conduct a reconciliation within 12 months of issuance or within 60 days of the end of the grant period for advance grant payments over \$50,000.<sup>22</sup> A reconciliation requires an agency to obtain documents (such as purchase orders, receipts, and payroll records) to substantiate that a grant recipient used grant money in compliance with grant agreements and other legal requirements. The State Arts Board did not comply with this requirement for the advance payments it made to the regional arts councils.
- An agency must review reports from grant recipients that show how grant money was used and what outcomes were achieved.<sup>23</sup> In its grant agreement, the board recognized it was responsible for “reviewing required reports and notifying the council of any failure to comply with laws and rules, or terms of this agreement....” The board told us that staff did review the final reports submitted by the councils but could not provide us with evidence that the reviews occurred. In addition, the board was not able to provide us with the standards and procedures it follows when reviewing grant recipient reports.

The control weaknesses noted above increased the risk that grant money may not have been used in compliance with state legal requirements.

Because the State Arts Board did not adequately monitor spending by the councils, we extended our testing to review financial reports submitted by two councils. For one of the councils, financial documents reported differing amounts of administrative costs.<sup>24</sup> One financial document showed the council may have used approximately 36 percent (\$188,651) of Arts and Cultural Heritage money for administrative expenses, while another document showed it had used approximately 5.6 percent (\$24,543) of revenue from all sources for administrative expenses.

Had the board provided effective oversight, it may have detected and clarified with council management the extent of its administrative spending and determined whether the council had complied with the “supplement not

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<sup>21</sup> For grants to recipients other than the regional arts councils, the board documented its justifications for advanced payments.

<sup>22</sup> Department of Administration, Office of Grants Management, Operating Policy and Procedure Number 08-10, *Policy on Grant Monitoring*.

<sup>23</sup> Department of Administration, Office of Grants Management, Operating Policy and Procedure Number 08-09, *Policy on Grant Progress Reports*.

<sup>24</sup> Region 2 includes Beltrami, Clearwater, Hubbard, Lake of the Woods, and Mahnomen counties.

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substitute” requirement in the Legacy Amendment or the “directly related to and necessary for” requirement in state law.

Even though the Legislature required the State Arts Board to grant money to the councils, the board still has a responsibility to establish adequate internal controls to ensure that councils are correctly using the money from the Arts and Cultural Heritage Fund. An Office of Grants Management policy clearly states that responsibility. It 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....<sup>25</sup>

Given the control weaknesses, and specifically the lack of monitoring by the board, we may more closely examine spending by the regional arts councils. But the possibility of an outside audit does not diminish the responsibility of the State Arts Board to ensure the councils are using money from the Arts and Cultural Heritage Fund in compliance with all state legal requirements.

#### *Recommendation*

- *The Minnesota State Arts Board should develop and implement adequate internal controls to monitor the regional arts councils.*

**The Minnesota State Arts Board used money from the Arts and Cultural Heritage Fund for administrative expenditures that it traditionally paid for with money from other funding sources. We believe this does not comply with the Legacy Amendment’s requirement that Legacy money must not be used to substitute for traditional sources of funding.**

## **Finding 2**

As we discussed earlier in this report, organizations that received money from the Arts and Cultural Heritage Fund or other Legacy funds have struggled to comply with two key legal requirements. First, agencies have struggled to comply with the legislative requirement that Legacy money can only be used for costs that are “directly related to and necessary for” implementation of programs and projects authorized in a law that appropriate Legacy money to the agency. Second, they have struggled with the constitutional requirement that Legacy money “must [be used to] supplement traditional sources of funding...and may not be used as a substitute.”

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<sup>25</sup> Department of Administration, Office of Grants Management, Operating Policy and Procedure Number 08-11, *Policy on Legislatively Mandated Grants*.

During the period covered by our audit, the Minnesota State Arts Board used approximately \$2.7 million from its appropriation of Arts and Cultural Heritage Fund money to pay for various administrative expenses. For the administrative expenses we tested, we were satisfied that the board complied with the “directly related to and necessary for” requirement. We were also satisfied that the total amounts used annually for administrative expenses was reasonable, ranging from a low of 3 percent and a high of 4 percent.

However, we identified approximately \$225,000 of administrative expenses the board paid from the Arts and Cultural Heritage Fund money that were previously paid for with General Fund money and other funding sources. These costs include rent, information technology services, the executive director’s salary, Financial Management and Report staff, and insurance.

During our audit, Arts Board staff defended their use of Arts and Cultural Heritage Fund money to pay these expenses. They emphasized the use of money from the fund resulted from a cost allocation method that is “efficient” and “rational,” and consistent with guidance provided by the Minnesota Department of Management and Budget (MMB).

In a written statement to us, board staff said:

MMB guidance says that agencies are responsible for the efficient and appropriate use of legacy dollars, and agencies are responsible for employing whatever form of organization and management techniques may be necessary for the efficient and reasonable administration of legacy funds given their unique staff, facilities, and background. Using an allocation method for some of our administrative costs is helping our agency operate most efficiently. MMB’s view is that using rational allocation methods are appropriate so that agencies are not subsidizing administrative costs associated with legacy funds [projects with other funding sources].

It is worth pointing out that the statement from board staff focused on the board’s compliance with the legislative imposed requirement that Legacy money must be used only for costs that are “directly related to and necessary for” implementation of projects authorized by laws that appropriate Legacy money. As noted previously, we agree that the board complied with this requirement. But complying with that requirement does not necessarily result in compliance with the constitutional requirement that Legacy money not be used to substitute for traditional sources of funding.

The statement we received from board staff seems to agree. It said:

In conclusion, we can state the following: that allocating costs does not ensure no supplanting of funds but it is allowable based on

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MMB guidance; that our agency analyzed each method of allocating before decided [sic] on our approach; MMB guidance states that requiring costs to be “direct and necessary for” does not prohibit agencies from paying for the full cost of administering legacy programs; MMB goes on to state that under the law and state policy, all state funds, including the legacy funds, should pay their portion of administrative costs, and not be subsidized by general fund or other dedicated funding sources....

Despite this strong defense, we believe the board’s method of allocating costs to its Arts and Cultural Heritage Fund appropriation did not fully comply with the Legacy Amendment’s “supplement not substitute” requirement.

#### *Recommendation*

- *The Minnesota State Arts Board should ensure that the money it receives from the Arts and Cultural Heritage Fund is used only for costs that “supplement traditional sources of money.”*

**The Minnesota State Arts Board did not challenge two grant recipients when it questioned whether costs met grant requirements. Despite the board identifying these questionable costs, it made an additional payment to one of these grant recipients.**

## **Finding 3**

During our audit scope, the Minnesota State Arts Board awarded approximately \$550,000 in Arts and Cultural Heritage Fund grants to two grant recipients: (1) Asian Media Access and (2) Pan Asian Alliance.<sup>26</sup> For all grants awarded by the Minnesota State Arts Board, the board pays 95 percent of the total grant award in advance and retains 5 percent until a final report is received and reviewed by the board.

When the board conducted financial reconciliations in March 2015 to compare costs charged to the Legacy Fund with the grant agreement, it questioned the two grant recipients’ use of Legacy money for one grant to Asian Media Access totaling \$100,000 and another to Pan Asian Alliance totaling \$60,000. For Asian Media Access, the board identified two performances that it did not approve, missing documentation for payments to performers, gas receipts for out-of-state travel, a receipt for a travel agency specializing in international travel, and other questionable costs. For Pan Asian Alliance, the board identified excessive mileage, unreadable receipts, out-of-state gas receipts, vehicle rentals that did not match project dates, and other questionable costs. After the board identified these costs, in May 2015, it made an additional payment to Asian Media Access for approximately \$7,000.

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<sup>26</sup> Asian Media Access is providing financial oversight for Pan Asian Alliance; therefore, Asian Media Access receives all Legacy money awarded to both grant recipients.

Although the board identified that these costs may not be allowable, they did not contact the grant recipients to obtain clarification or additional documentation. Board procedure requires that “Notice will be given within 60 days of the Arts Board becoming aware of a grantee’s failure to meet requirements.”<sup>27</sup> As of the end of October 2015, board staff informed us that they still had not taken steps to determine whether noncompliance had occurred.

In addition, the board did not notify our office about the possible unlawful use of public money. State statute requires:

The chief executive, financial, or information officers of an organization...[to] promptly notify the legislative auditor when the officer obtains information indicating that public money or other public resources may have been used for an unlawful purpose.<sup>28</sup>

By not resolving questions with the grant recipient, not contacting OLA, and continuing to issue payments, the board increases its risk that the grant recipients may misuse or continue to misuse grant money.

#### *Recommendation*

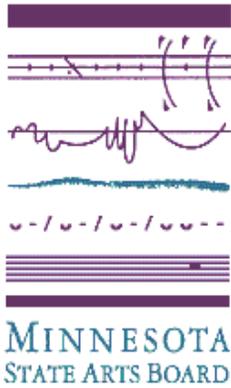
- *The Minnesota State Arts Board should follow up with grant recipients when it questions whether money used met the grant requirements.*

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<sup>27</sup> The Minnesota State Arts Board implemented guidance to identify consequences that will ensue if a grant recipient does not comply with grant requirements.

<sup>28</sup> *Minnesota Statutes* 2015, 3.971, subd. 9.

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November 10, 2015

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

Dear James Nobles,

The Minnesota State Arts Board appreciates the careful and thorough review the Office of the Legislative Auditor has recently completed of our agency's internal controls and compliance related to arts and cultural heritage fund expenditures.

The Arts Board places the highest priority on stewardship of State funds and welcomes suggestions on ways that we can strengthen and clarify our procedures.

***Finding 1*** — The Minnesota State Arts Board did not establish adequate internal controls to ensure that regional arts councils used \$22 million in grants from the arts and cultural heritage fund in compliance with legal requirements.

***Agency response*** — Minnesota's eleven regional arts councils were created in the late 1970s to ensure that state funds would be available in every county of the state. Each regional council receives a block grant from the Arts Board and has local authority to use those funds to meet the highest needs and invest in the most promising opportunities in its specific area of the state. The relationship between the board and the regional councils is close and longstanding; together the board and councils comprise a system that effectively serves the entire state, and a system that has served as a model for other states.

200 Park Square Court  
400 Sibley Street  
Saint Paul, Minnesota  
55101-1928

(651) 215-1600  
(800) 866-2787  
Relay 7-1-1  
[www.arts.state.mn.us](http://www.arts.state.mn.us)

Regional arts councils' biennial plans and projected budgets are reviewed by staff and board members. Its subsequent reports and financial documents are reviewed by agency staff. Historically, these reviews have not been documented in written form; going forward such reviews will be documented. The example OLA cites, regarding one council's administrative expenses, illustrates the likely benefit of such documentation. In this example, the council's internal financial statements lumped program and administrative costs together which resulted in an amount that was reflected as 36 percent of its expenses; however its independent certified audit properly separated those costs and accurately reported 5.6 percent in administrative expenses. This level of administrative expenses is reasonable so would not have raised a concern for the Arts Board. Had this explanation been noted in the council's file, the auditors may not have raised a question. In addition, the agency will keep a written copy of the justification for advance payments to regional arts council in the grant file. And finally, the Arts Board will work with the regional arts councils and their independent auditors to develop a process by which reconciliation of grant payments can be most effectively and efficiently completed.

*Person responsible* — Sue Gens, executive director

*Complete by* — June 30, 2016

*Finding 2* — The Minnesota State Arts Board used money from the arts and cultural heritage fund for administration expenditures that it traditionally paid for with money from other funding sources. We believe this does not comply with the legacy amendment's requirement that legacy money must not be used to substitute for traditional sources of funding.

*Agency response* — In the body of this report, the OLA cites Minnesota Statutes 2015, 645.16: "When the words of the law in their application to an existing situation are clear and *free of all ambiguity* [emphasis added], the letter of the law shall not be disregarded under the pretext of pursuing the spirit." Elsewhere in this report, the OLA states that "the meaning of the 'supplement not substitute' requirement is uncertain." Given the ambiguity of the "supplement not substitute" requirement, each agency must use its best judgment to adhere to the spirit of the law. While we appreciate the questions raised by the OLA, and look forward to continuing the conversation with the OLA and with legislators to clarify this requirement, we believe that we are in compliance with the intent of the requirement.

An argument can be made that the "directly related to and necessary for" requirement adds some clarity that is lacking in the "supplement not substitute" constitutional language. In this report, the OLA states that "For the administrative expenses we tested, we were satisfied that the board complied with the 'directly related to and necessary for' requirement." If the board is spending funds in ways that are *necessary* to administer legacy funds, then how is possible that *substituting* is taking place since those costs did not exist prior to legacy and therefore were not supported by traditional sources of funding?

This audit finding does not take into account two realities brought about by legacy funds. First, because general fund appropriations to the board had been declining since its high water mark in the 2000-2001 biennium, “traditional costs” incurred prior to the legacy amendment were and would continue to have been reduced or eliminated entirely. Second, the responsibilities of staff members, the use of space, and use of information technology, all changed radically due to the sudden, significant increase in legacy funding and the required need to administer the funds.

Costs that had been covered by traditional funding sources have evolved, or have been replaced by new and different costs. Arts Board staff, information technology, and space are being used in ways that did not exist prior to legacy, therefore, there is no traditional source of funding for these costs. For example, costs of an executive director’s salary to manage the Arts Board were being covered by traditional sources, but after legacy the executive director’s management responsibilities increased significantly and the majority of the additional work load is related to legacy funds, not to programs or services supported by general fund or federal dollars. These new responsibilities had not existed prior to the passage of the legacy amendment, so therefore had never been covered by traditional sources.

In its “Guidance to Agencies on Legacy Fund Expenditures,” Minnesota Management and Budget states that “Under law and state policy, all state funds, including the legacy funds, should pay their portion of administrative costs, and not be subsidized by the general fund or other dedicated funding sources.”

The Arts Board will continue to carefully allocate administrative costs to legacy funds, and document the rationale for those allocations.

We believe the legislature has used the “directly related to and necessary for” requirement to bring some otherwise lacking specificity to the constitutional requirement. If further conversations among the Office of the Legislative Auditor, the legislature, and agencies receiving appropriations could add further clarity to ambiguous, and at times seemingly contradictory, requirements we would welcome the opportunity to be part of those conversations.

*Person responsible* — Sue Gens, executive director

*Complete by* — Ongoing

*Finding 3* — The Minnesota State Arts Board did not challenge two grant recipients when it questioned whether costs met grant requirements. Despite the board identifying these questionable costs, it made an additional payment to one of these grant recipients.

*Agency response* — In FY 2012, the board established procedures and a timeframe in which to deal with grantees that may have used funds in ways that were not allowed. In its FY 2014 grant cycle, the Arts Board began reconciling grants, as required by Office of Grants

Management policies. Reconciliation procedures were created and communicated to grantees. This new requirement created substantial extra effort for grantees, especially for smaller organizations, and for the Arts Board.

The board did identify questions related to the two grants noted by the OLA. This was the first time reconciliation had raised substantive questions that could not immediately be resolved, so we needed to develop a process by which a grantee could respond and clarify its use of funds, so that questions could be resolved and any necessary next steps could be taken. The report correctly states that we did not resolve those questions within the timeframe called for in our procedures. And, since it had not, yet, determined that there was unlawful use of funds, the board did not notify OLA.

The board will review its procedures and timeframes to determine how it might be able to resolve questions in a more timely manner, and it will notify OLA when such a step is warranted.

*Person responsible* — David White, director, finance and grants administration  
*Complete by* — January 31, 2016

Each member of the Office of the Legislative Auditor's team that worked on this audit demonstrated a very deep commitment to accountability. For that we, and all Minnesotans, can be thankful. We appreciate the opportunity to address the findings and recommendations in this audit report and will be happy to answer any questions that may be prompted by this response.

Sincerely,



Susanne K. Gens  
Executive director