



Internal Audit Closure Report

School Trust Fund Risk Assessment

Issued April 25, 2014

Internal Audit reviewed risks related to financial and land management activities of the School Trust Land. We determined the scope of the review from a comprehensive risk assessment developed by the School Trust Land Administrator. Our objectives were to 1) examine significant constraints or barriers that could adversely affect the department's ability to manage the trust and 2) assess the extent to which informed decisions are made regarding trust fund activities. Specifically, we reviewed risks related to compliance with statute and department policy, forest certification, and funding the operational expenses of trust management.

Legislative oversight through the Legislative Permanent School Fund Commission (LPFSC) is a primary system control. The department developed Operational Order 121 to clarify its policy on management of school trust lands and an independent administrator was appointed to coordinate the school trust land management activities. Minnesota Statute and department policy requires that the DNR secure maximum long-term growth with sound natural resource management principles. Since the administrator's appointment in calendar year 2012, reducing shorter term risks has been the focus and the measure of success including developing an inventory framework and a process and review steps to arrive at highest and best use classifications for the school trust lands. With the fiduciary responsibilities required of the department, a focus on longer-term strategies and clarification of inconsistencies is needed to increase accountability to current and future beneficiaries. We noted the following issues:

Policies and Procedures: The department lacks formal procedures to guide school trust administration and the divisions in the decision-making processes necessary to ensure that DNR management of school trust land complies with statutory and department requirements.

- **Oversight**

The administrator position is expected to establish strategic direction that guides agency decision making in all matters related to school trust land management. Informal processes and collaboration with the divisions have been in place creating risks that school trust activities are not fully represented in division decisions. For example, an internal memo from EWR to (NE FRIT) issued in calendar year 2013 did not address the fiduciary duty to school trust lands when removing school trust timber resources from the annual harvest list. Developing written processes to re-direct and structure formal authority will provide necessary leadership to all DNR divisions who manage trust lands.

The divisions do not have a system in place to route management reports to the school trust administration. The oversight and accountability requirements require that the administrator receive and evaluate pertinent information relating to trust function activities. The absence of this information from the divisions undermines the day to day management and limits the administrator's

ability to understand and evaluate the transactions and to correct any deficiencies when needed. For example, the administrator must provide annual revenue forecasts, projections, operating expenses, market trends and performance metrics. But, the administrator and divisions have not established a system by which divisions provide revenue and performance reports and other elements such as program business plans.

- **Trust Compensation:**

MN Statute and department policy requires compensating the trust when restrictions and prohibitions are placed on trust land. Risks of non-compliance with statutory and department requirements will be reduced when the department formalizes reimbursement procedures to support the proposed DNR compensation plans. Guidance in decision making and compliance plans are needed including monitoring procedures and visits to check on whether staff is following procedures.

- **Sustainable Long-Term Growth – Permanent School Fund**

Legislative changes in 2012 clarified that when managing school trust lands, the DNR must give precedence to economic returns if irresolvable conflicts arise between economic returns and natural resource or recreation values. Trust administration is in the planning phase of developing a business plan to address trust priorities, such as: further defining highest and best use of trust lands by parcel; developing formal methodology for defining market share and market competition to improve marketability and the potential to generate revenue. Limited resources impact the achievement of these proposed goals. The department has not formally evaluated the degree to which these activities can be accomplished by one individual. The administrator's ability to coordinate and lead without involvement in the day to day activities of the trust management is an important issue in conjunction with the evaluation of risks attributed to unrealistic assumptions and insufficient resources that could adversely affect the department's ability to manage the trust.

Forest Certification

The department participates in two forest certification programs, the Forest Stewardship Council (FSC) and Sustainable Forestry Initiative (SFI). By adopting forest certification, the department has voluntarily agreed to maintain a well-managed forest and a standard of forest management that is ecologically, socially and economically sustainable. The department has not evaluated whether forest certification is a net-positive program including analyzing the cost/benefits and potential advantages. Potentially, the department could conduct research and clarify which certification creates more economic value including how the certifications impact the markets, and examining any uncertainties and unsolved issues of certification. For example, the department has not developed a model to determine the amounts due, if any, for restricting timber harvests on high conservation value forests. Also, the department should analyze the cost of designating school trust lands as high conservation value forests under FSC standards.

Funding Operational Expenses of Trust Management

The legislature directed DNR to reduce its school trust management expenditures in MN Statute 84.027 Subd. 18 (2). Currently, the DNR manages school trust lands under two funding scenarios. The operating costs of DNR management of forest and real estate assets are recaptured by the DNR pursuant to the forest cost certification in Minnesota Statutes, section 16A.125. The DNR's operating costs related to mineral management is a direct appropriation up to \$3 million per Minnesota Statutes, section 93.2236. These two funding methods for school trust management do not provide sufficient details, which has led to transparency and accuracy concerns.

Operating costs are allocated by two methods. The costs of mineral management on school trust land is financed with an appropriation from trust land mineral revenues. Forest management costs are allocated based on the percentage of total timber sale revenues that are generated from trust land.

Forestry manages based on gross revenues from the school trust land, and does not accurately capture direct management costs on school trust land. Instead, Forestry certifies its costs based on a percentage of school trust land within a specific Forestry area regardless of whether or not actual management occurred. Forestry certifies administrative costs under MN Statute 16A.125, and those costs continue to rise. However, an explanation of these costs is not identified in the fiscal cost certification report. In contrast, the division of Lands and Minerals provides a percentage breakdown of overall mineral management costs of school trust minerals without providing reports of administrative costs.

An additional concern is that cost allocation methods vary among the divisions causing the DNR to subsidize forest management costs. The DNR subsidizes school trust land management annually, with an annual subsidy amount of \$3.5 million dollars.*

Recommendations:

- Establish strategic direction that guides agency decision making in all matters related to school trust land management.
- Develop a reporting system to ensure that the divisions provide pertinent information to the administrator.
- Implement a plan to address its compliance with statutory and department requirements for compensating the trust. Develop formal processes when restrictions and prohibitions are placed on trust land and the various reimbursement methods including procedures for condemnations, land exchanges, real estate contracts and modifications to current DNR management.
- Further define the business plan to address the current and long-term priorities and further define the activities to be accomplished to achieve the proposed goals. Evaluate staffing needed to achieve the proposed goals and determine the potential adverse impact on trust management activities.
- Perform a cost benefit analysis of forest certification. The analysis should determine how certification impacts the markets and whether there are financial incentives to maintain certification. Both direct and indirect costs should be incorporated into the analysis.
- Reexamine the cost allocation for forest management costs to determine if costs are accurately linked to revenue generated from timber sales. Include an analysis of professional services rates to determine if they exceed the actual costs of services with an emphasis on reducing operating costs on school trust lands.
- Formally evaluate DNR's subsidy of forest management costs.

*Page 6-7 MINNESOTA'S SCHOOL TRUST LANDS BIENNIAL REPORT Fiscal Years 2012-2013 (7/1/2011 – 6/30/2013). http://www.dnr.state.mn.us/aboutdnr/school_land/reports.html

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