

# PERFORMANCE AUDIT REPORT

## Department of Trust Lands Trust Assets and Department Resources

Report No. 3036(c)  
(Report 3 of 3)  
March 18, 2016



STATE OF NORTH DAKOTA  
**OFFICE OF THE STATE AUDITOR**  
STATE CAPITOL  
600 E. BOULEVARD AVENUE – DEPT 117  
BISMARCK, NORTH DAKOTA 58505

March 18, 2016

Honorable Jack Dalrymple, Governor

Members of the North Dakota Legislative Assembly

Lance Gaebe, Commissioner, Department of Trust Lands

We are pleased to submit this performance audit report on aspects of the Department of Trust Lands. Specifically, this report contains the results of our review to determine whether the Department of Trust Lands is obtaining, accounting for, and using resources efficiently and effectively. The report is the third of three reports issued by our office in conjunction with the performance audit of the Department of Trust Lands.

The audit was conducted at the request of the Legislative Audit and Fiscal Review Committee. We conducted this audit under the authority granted within North Dakota Century Code Chapter 54-10. Included in the report are the objectives, scope, recommendations, and management responses.

Sincerely,

A handwritten signature in cursive script that reads "Bob Peterson".

Robert R. Peterson  
State Auditor



# OFFICE OF THE STATE AUDITOR

## Performance Audit – Trust Assets and Department Resources

### Report Highlights

#### **Purpose**

Determine whether the Department of Trust Lands is obtaining, accounting for, and using resources efficiently and effectively.

#### **Audit Conclusion**

We determined the Department was not obtaining, accounting for, and using certain resources efficiently and effectively.

#### **Audit Recommendations**

Our audit resulted in 29 formal recommendations related to the audit objective. The Department agreed with 22 of the 29 recommendations. The recommendations and management agreement/disagreement are identified in Appendix A of the report. There are 9 Office of the State Auditor concluding remarks in this report.

#### **Background**

The Board of University and School Lands (Land Board) has control of various grant and acquired lands, the minerals under sovereign lands (navigable rivers/lakes), and other statutory funds. The Department of Trust Lands (Department) is responsible for the supervision of trusts and assets under the control of the Land Board. The state's oil and gas development has impacted trust assets and Department resources. Since the end of the 2009-11 biennium to the end of the 2013-15 biennium, the number of appropriated full-time equivalent positions has increased from 21.75 to 31. For the same time period (per the Department's audited financial statements):

- Total fiscal year revenues have increased from approximately \$623 million to \$1.3 billion (high of \$1.5 billion in fiscal year 2013).
- Investments have increased from approximately \$1.9 billion to \$3.6 billion.

#### **Summary Information**

- The wrong trust had been assigned to certain tracts in the Department's databases. As a result, net assets of trusts and distributions to beneficiaries were negatively impacted. (page 1)
- Certain mineral royalty payments received by the Department did not appear to be correct. (page 4)
- The Department allocated portions of royalty payments received to the wrong trusts. (page 5)
- The Department was not actively attempting to collect interest and was not consistently charging penalties on late royalty payments. (pages 8 & 9)
- Improvements are needed in the calculation of minimum opening bids on pastureland to ensure the Department is obtaining a fair market return on the land. (page 11)
- The Department was not fulfilling fiduciary responsibilities and there was a lack of an organizational culture of accountability. (page 16)
- Improvements are needed with the accounting of expenditures to ensure costs are allocated to the applicable trust, program, or activity. (page 22)
- There was noncompliance with the Department's Code of Ethics as employees' actions created an appearance of losing independence or impartiality. (page 24)
- An individual not meeting the minimum qualifications of a position was hired even though the Department was aware the minimum qualifications were not met. (page 28)
- The Department's information technology system is old, difficult to maintain, and lacks collaboration of certain information. (page 34)

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- Appendix B: Tract and Trust Information
- Appendix C: Chapter 1 Supplemental Responses & Concluding Remarks
- Appendix D: Chapter 2 Supplemental Responses & Concluding Remarks

## Surface and Mineral Areas

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### Introduction

An objective of this performance audit was to answer the following question:

“Is the Department of Trust Lands obtaining, accounting for, and using resources efficiently and effectively?”

We determined the Department of Trust Lands (Department) was not obtaining, accounting for, and using certain resources efficiently and effectively. Significant improvements needed by the Department relating to surface and mineral areas are included in this chapter. Improvements of less significance were communicated in a separate letter to management of the Department. To conduct a review of surface and mineral areas, we:

- Reviewed applicable laws and policies.
- Reviewed information related to trusts assigned to tracts.
- Reviewed information related to royalty payments.
- Selected surface and mineral tracts, wells, and various other information.
- Reviewed information related to auctions.
- Reviewed information related to monitoring surface and mineral tracts.
- Interviewed selected personnel.

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### Background Information

In 1889, Congress passed the Enabling Act which provided land grants to the State of North Dakota for the support of the common schools as well as colleges, universities, the state capitol, and other public institutions. The Department manages trusts and tracts of land for the various beneficiaries. The tracts are leased by the Department to generate income for the trusts assigned to the tracts. Leases are entered into giving lessees the rights to the use of surface acres and the rights to mineral development. Examples of surface leases include agricultural, right-of-way, and salt water disposal well. Examples of mineral leases include oil, gas, and coal. See Appendix B for additional information related to trusts and tracts.

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### Ensuring Trusts Assigned to Tracts are Correct

A trust is assigned to every surface tract and mineral tract managed by the Department. Except in rare circumstances, when the state owns both the surface and mineral rights to a tract, the same trust will be assigned. The Department’s surface and minerals databases contain information related to the tracts under management and the trust assigned to each tract. The Department relies on the trust assignments in the databases to credit revenues generated by the tracts to the respective trusts. We reviewed the Department’s databases in an attempt to gain assurance the Department had correctly assigned trusts to tracts.

As part of our review, we selected 40 surface tracts and reviewed documentation to determine whether the correct trusts had been assigned to the surface tracts. The trusts assigned to the 40 surface tracts appeared

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## Chapter 1 Surface and Mineral Areas

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correct. Next, we compared the trusts assigned to the 40 surface tracts to the trusts assigned to the corresponding mineral tracts. We identified one mineral tract did not appear to be assigned to the correct trust.

**We identified mineral tracts were assigned to the wrong trust.**

With the identification of a tract apparently assigned to the wrong trust, we then attempted to perform a comparison of the trusts assigned to the surface tracts and the trusts assigned to the corresponding mineral tract. Due to differences in the two databases and the difference in the number of surface and mineral acres, our comparison was limited. We identified 5 mineral tracts were apparently assigned to the wrong trust. None of the 5 had a lease for oil and gas.

In review of the 5 instances, a problem appeared to exist with the Department assigning the mineral tracts of the Ellendale trust to the trust for the Youth Correctional Center (YCC). There appears to have been confusion related to the trust names. Tracts assigned to the Ellendale trust were originally classified as “Industrial” school. Tracts assigned to the YCC trust were originally classified as “Reform” school. Background information related to the school names included in state law for YCC and Ellendale follows:

- In 1890, a State Reform School was established at Mandan. In 1921, the school was renamed to the State Training School. In 1961, the school was renamed to the North Dakota Industrial School. In 1995, the school was renamed to YCC.
- In 1893, an Industrial School and School for Manual Training was established at Ellendale. In 1907, the school was renamed to the State Normal and Industrial School. In 1973, the state law chapter related to the school at Ellendale was repealed (the school had a fire in 1970 effectively closing the school).

When the Department began developing and transitioning to electronic databases in the 1980’s, information related to tracts and the assigned trusts was manually entered. Since the information has been entered, the Department appears to have relied on the information in the databases as being correct. However, in certain instances when an “Industrial” tract was entered, the trust assigned was YCC (at the time of entering data, YCC was called the Industrial School). We conclude “Industrial” tracts should have been assigned to the Ellendale trust.

**The YCC trust has received moneys belonging to the Ellendale trust.**

Once we were aware of Ellendale tracts being assigned to the YCC trust, we reviewed 20 of the 120 leased mineral tracts assigned to the YCC trust (selected tracts with the highest bonus payments). We identified 7 had the wrong trust assigned (Department agreed). Based on information provided by the Department on the 7 tracts, approximately \$2.8 million had been incorrectly credited to the YCC trust (through January 2016).

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The Department took no actions when a review performed in 2011 identified trusts may have been incorrectly assigned to tracts.

We requested information from the Department related to reviews or monitoring of trusts assigned to tracts. The Department provided information related to a review conducted in 2011 by the former Director of Revenue Compliance. The information clearly indicated a potential problem existed with trusts being incorrectly assigned to tracts. However, the Department did not take actions necessary to confirm and/or correct the problem.

The Department's review indicated the YCC trust may have been incorrectly assigned to certain tracts including the tracts we concluded were errors. The review also indicated certain trusts may have been incorrectly assigned to tracts beyond the YCC/Ellendale concerns we noted.

When the Department incorrectly assigned trusts to tracts, the royalty payments submitted to the Department were credited to the wrong trust and would have resulted in investment income being generated for the wrong trust. As a result, the net assets reported by the Department for certain trusts were wrong. Since the distributions to beneficiaries of the trusts were based on the net asset amounts, distributions would also have been negatively impacted.

### Recommendation 1-1

We recommend the Department of Trust Lands:

- a) Ensure tracts of land managed by the Department are assigned to the correct trust.
- b) Obtain guidance from legal counsel on correcting net assets and past distributions for trusts incorrectly assigned to tracts.

### Management's Response

The Department agrees with these recommendations. Files and all properties pertaining to assets inappropriately assigned to the Youth Correctional Center Trust in the 1940s will be reviewed and corrected. Additionally, the Department will review all mineral tracts in the YCC Trust for other potential errors.

The audit finding correctly states that the asset balance of the YCC Trust is inflated by \$2.8 million due to the error and recent mineral revenue produced by the seven tracts. Additionally, this amount generated investment income of approximately \$523,000. The collective impact of the error on distributions over the past five years is that the YCC received approximately \$177,000 more and the seven beneficiaries of the Ellendale Trust received that much less. The authority to correct these mistaken appropriations will likely need to be requested from the legislature. The Department will obtain guidance from the Attorney General's Office on appropriate methods to correct net assets, trust transactions and distributions in which tracts and resulting revenues were incorrectly assigned to trusts.

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### State Auditor's Concluding Remarks

While the Department agrees with the recommendation, the response focuses on the YCC issue. We want to clarify for all users of the report – the issue of trusts being assigned to the wrong tract may extend beyond just YCC. We also want to emphasize – the \$2.8 million is the error amount for only 7 tracts (reviewed 20 of 120 tracts assigned to YCC). Based on the Department's review in 2011, we would anticipate the final error amount (to be determined by the Department) will be higher, thus having greater dollar amounts needing to be corrected.

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### Ensuring Correct Interest in Wells

In determining the amount of money the state will be paid on each dollar of revenue a well produces, the state's decimal interest has to be calculated. The basic decimal interest calculation formula is:

$$\frac{(\text{State owned acres in spacing unit}) \times (\text{Lease royalty rate})}{\text{Acres in spacing unit}}$$

Information related to each aspect of the decimal interest formula follows:

- Spacing unit: The spacing unit is the area in each pool assigned to the well for drilling, producing, and proration purposes. When a well is permitted by the North Dakota Industrial Commission, the spacing unit is identified (typically 640 or 1,280 acres).
- State owned acres in spacing unit: Within the spacing unit, the state may own mineral rights to one or more tracts of land. The state may also only have ownership of a percentage of the mineral rights. For example, when a tract of land was sold by the state, it may have retained only 50% of the mineral rights. If such a tract is included in the spacing unit, when calculating the decimal interest the state owned amount would be the mineral tract acres times the state ownership of the mineral rights.
- Royalty rate: The royalty rate represents the share of oil and gas production revenue the owner is entitled to. The royalty rate is established in oil and gas leases. The leases entered into by the Department have various royalty rates including 1/6, 1/8, and 3/16.

In determining the amount to be paid to the state on oil and gas production, the volume produced is multiplied by the sales price and the state's decimal interest. The resulting amount, less any allowable deductions, is what is owed to the state.

The Department compared the decimal interests reported by operators in royalty reports to the decimal interests in the minerals database. The Department compiled a list of potential concerns as decimal interest numbers reported by operators were not the same as the decimal interest calculated by the Department. The Department's list required additional reviews be performed to determine whether or not there was an error with the decimal interest number used by the operator or if the Department's

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calculation was wrong. However, the Department was only reviewing the list of concerns as time allowed and had not dedicated the necessary resources to complete the reviews.

Certain royalty payments received by the Department appear incorrect.

We selected 5 wells from the Department's list. Based on information provided by the Department, the wrong decimal interest appears to have been used by operators in calculating royalty payments related to 4 of the 5 wells. For example, the Department had received royalty payments for a well of approximately \$136,000 since March 2012. Using what the Department calculated to be the correct decimal interest, the Department should have received approximately \$64,000 more than what was received. Using the Department's information, it appears the incorrect decimal interest on the 4 wells resulted in approximately \$120,000 not being received by the Department.

### Recommendation 1-2

We recommend the Department of Trust Lands:

- a) Conduct a formal review of oil and gas royalty payments to ensure amounts received were based on the correct decimal interest.
- b) Establish a periodic review to ensure operators are using the correct decimal interest.

### Management's Response

The Department agrees with these recommendations. The Department has begun to implement the suggested changes. In the fall of 2015, the Department adjusted system requirements so mineral ownership is calculated to eight decimal places. The Department has initiated a formal review of oil and gas interests to compare the trusts' documented decimal interest to the interest paid by operators and verify that operators are using the correct decimal interest.

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## Ensuring Royalty Payments are Properly Allocated

A producing well can be extracting oil and gas from multiple tracts managed by the Department. As a result, a royalty payment received by the Department for a well may require the payment to be allocated to more than one trust. The Department has established payment codes for each well. The payment code is used to allocate the amount each trust will receive of a royalty payment.

The Department allocated portions of royalty payments to the wrong trusts.

In interviews with Department personnel, issues with payment codes incorrectly allocating royalty payments were discussed. The Department had previously identified instances of payment codes being incorrect and trusts receiving the wrong amount of royalty payments. Examples of errors identified and actions taken to address the errors include:

- A payment code originally established for a well inappropriately included a tract of land assigned to the North Dakota State College of Science (NDSCS) trust. The trust had no tract included in the spacing unit of the well. As a result, the NDSCS trust was allocated a portion of the royalty payment it was not entitled to for over seven years

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(approximately \$84,000). The Department made a correcting entry to transfer \$84,000 from the NDSCS trust to the Common Schools trust.

- A payment code originally established for a well did not properly include a tract of land assigned to the North Dakota State University (NDSU) trust. As a result, the University of North Dakota (UND) trust received a larger portion of the royalty payments than it was entitled to over a three and a half year time period (approximately \$85,000). The Department made a correcting entry to transfer approximately \$85,000 from the UND trust to the NDSU trust.

When the Department did identify payment allocation errors and made correcting entries, only the oil and gas royalty revenue credited to the wrong trust was transferred. The correcting entries did not include consideration for interest or investment income earned inappropriately by a trust. As a result, the transfers made did not include an amount for lost revenue by a trust not receiving the royalty payments it was entitled to. The Department has no policy established for calculating lost revenue to make a trust whole when an error is identified.

When the Department incorrectly allocated royalty payments, the royalty payments submitted to the Department were credited to the wrong trust(s). As we address in a previous section of the report, when a trust is credited with another trust's revenue, the net assets and distributions to beneficiaries are negatively impacted.

At the time audit work was performed, the Department was in the process of developing a new system for mineral information. The Department had compared information between the current database and the system being developed. The Department's comparison identified differences in information related to certain wells. We performed a limited review of 18 differences and identified payment codes needed to be updated. Examples include:

- The acres within a spacing unit of a well changed and the Department had not identified or was unaware the acres had changed. As a result, the necessary change to the payment code was not made. For example, a well was originally approved as a 1,280 acre spacing unit. However, when the spacing unit was changed to 2,560 acres, the payment code was not updated to include additional tracts within the larger spacing unit. Information provided by the Department identified approximately \$89,000 has been credited to the wrong trust. The Department will need to make a correcting entry.
- When the Department made changes to acreages in the minerals database, the payment codes were not automatically updated. Certain Department representatives making the changes appeared to be unaware payment codes were not automatically updated. As a result,

**The Department did not properly update payment codes for allocating royalty payments.**

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payment codes were not always being updated even when the Department was aware a change in acreage had occurred.

### Recommendation 1-3

We recommend the Department of Trust Lands:

- a) Ensure oil and gas royalty payments are correctly allocated to the proper trusts.
- b) Obtain guidance from legal counsel on correcting net assets and past distributions for royalty payment allocation errors.

### Management's Response

The Department agrees with these recommendations. The Department will continue to work to ensure that royalty payments are allocated to the proper trust and make adjustments as needed. The Department will request guidance from the Attorney General's Office on appropriate methods to correct net assets, trust transactions and distributions where tracts and resulting revenues were incorrectly assigned to trusts.

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## Capturing Data and Auditing Operators

Oil and gas operators are required to submit a royalty report to the Department with the royalty payment. During the audit time period, we identified:

- The Department did not require operators to use a standard form for reporting information.
- The Department did not require operators to submit information in an electronic format.
- While the Department had a contract with a vendor to allow operators to provide information in an electronic format, there was no standard format for providing information.

Due to the factors above, inconsistencies exist with the information in the Department's database. The Department was expending a significant amount of resources manually entering royalty report information and paying for the information submitted through the third party vendor. In addition, not all information necessary to perform reviews of payments was being manually entered. As a result, reviews the Department was attempting to perform on the accuracy of royalty payment amounts were limited and not as efficient and effective as they could have been. There was limited assurance royalty payments received were correct and trusts may not have received correct revenue amounts.

The Department had limited assurance royalty payments received were correct.

The Department was not performing audits of the oil and gas operators submitting royalty payments. As a result, the Department was not obtaining or reviewing source documents (sales contracts, run tickets, etc.) to ensure payments were accurate.

Even though audits of operators were not conducted and various factors limited the efficiency and effectiveness of the reviews being performed, the Department's Revenue Compliance Division has reported over \$23

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million has been recovered through collection efforts (according to Department information for fiscal years 2012 through 2015). Based on discussions with Department personnel, implementation of a required electronic royalty reporting form started in October 2015. Also, documentation from oil and gas operators was starting to be collected by the Department to begin auditing royalty payments. While apparent changes are being implemented, the Department went an extended period of time (including during the oil boom) with limited assurance royalty payments received were correct.

### Recommendation 1-4

We recommend the Department of Trust Lands:

- a) Ensure information submitted with oil and gas royalty payments is consistently obtained in an electronic format and includes all necessary information to adequately monitor payment amounts.
- b) Conduct audits of oil and gas operators submitting royalty payments to the Department.

### Management's Response

The Department agrees with these recommendations. Since October 1, 2015, the Department has required that oil and gas operators submit royalty information electronically via the Department's standard form which includes all necessary information for adequate monitoring. During the 64th Legislative assembly, an FTE was authorized for additional compliance audit efforts. The Department commenced a comprehensive oil and gas audit of a major oil and gas producer starting in September 2015 and has developed an audit schedule to review more operators for compliance with the Board's lease and rules. In addition, in February 2016 the Department began procurement efforts for contracted royalty audit firms to assist with verification and collection efforts.

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## Assessing Interest on Late Payments

North Dakota Century Code Section 47-16-39.1 includes information related to interest on unpaid royalties. If an operator fails to pay oil or gas royalties to an owner within 150 days after oil or gas produced is marketed, the operator is required to pay interest on the unpaid royalties. State law establishes an interest rate of 18%. However, for unpaid royalties on minerals managed by the Department, the Commissioner may negotiate a rate to be no less than the prime rate established by the Bank of North Dakota plus 4% with a maximum rate of 18%.

The Department was not actively attempting to collect interest on late payments.

While state law requires operators to pay interest on late oil and gas royalties, the Department was not actively attempting to collect interest. The information system used by the Department does not automatically calculate interest on late royalty payments. As a result, Department personnel are required to perform manual reviews to identify late payments and manually calculate the interest amount owed. In a limited review of information related to late oil and gas royalty payments, we identified an operator had paid interest for a late payment. However, the interest rate used was the minimum rate allowed by state law. There

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## Chapter 1 Surface and Mineral Areas

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appeared to have been no negotiation as required by state law for the interest rate used by the operator. Also, the Department has not established an interest rate to be assessed on late payments or a policy identifying circumstances under which interest will be assessed.

### Recommendation 1-5

We recommend the Department of Trust Lands establish:

- a) An interest rate to be assessed on late oil and gas royalty payments.
- b) A policy identifying the circumstances under which interest will be assessed.

### Management's Responses

The Department disagrees with these recommendations. See Appendix C for the Department's complete response.

### State Auditor's Concluding Remarks

See Appendix C for State Auditor's concluding remarks.

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## Assessing Penalties Consistently

The Department's oil and gas leases include information related to royalty payment due dates and when payments are considered delinquent. Within 90 days following the initial production of oil and within 120 days following initial production of gas, lessees are required to submit a payment with a royalty report to the Department. After the initial production, lessees are required to submit payments on a monthly basis. According to the lease requirements, any sum "not paid when due shall become delinquent and will be subject to a delinquency penalty of one percent . . ."

The Department was not assessing penalties on late payments in a consistent manner.

Penalties on late payments should be assessed in a consistent manner to ensure operators are treated in a fair and equitable manner. In a limited review of information related to late oil and gas royalty payments, we identified inconsistencies and errors with assessing penalties. Examples include:

- An operator was not assessed a penalty on payments delinquent by more than 90 days. However, an operator was assessed a penalty on a payment 30 days delinquent.
- While the lease requires a monthly royalty payment be submitted, the Department has allowed certain operators to pay using the operators' normal billing cycle (exceeds 30 days). The Department does not assess penalties for operators paying on their normal billing cycle.
- Penalties calculated by the Department were done incorrectly for certain penalties assessed. Penalties are not automatically calculated by the system.

### Recommendation 1-6

We recommend the Department of Trust Lands ensure penalties are consistently assessed on late oil and gas royalty payments and calculations are accurate.

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## Chapter 1 Surface and Mineral Areas

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### Management's Response

The Department disagrees with this recommendation. Board Rule 85-06-06-10 states that the Commissioner may collect penalties, interest, or both upon delinquent royalty payments. This rule provides discretion of the application of penalties due to payment complexities including title disputes, lease assignments, and timing issues. This flexibility is useful in the negotiation and collection of royalties - which is the objective. It is conceivable that unyielding policies would encourage litigation, thus the Department will consult with its legal counsel regarding the appropriateness of adjusting the Board's oil and gas royalty rules to require penalties. Consistent with the recommendation, the Department will work to ensure that calculations are accurate and improve consistency on application of penalties.

### State Auditor's Concluding Remarks

The Department's response is contradictory and misleading. While the Department disagrees with the recommendation, the last sentence states the Department will take actions consistent with the recommendation. The recommendation is intended to increase fairness and would provide guidance for enhancing the consistent assessment of penalties under similar circumstances. The Department states it is conceivable unyielding policies would encourage litigation. However, we are concerned the current practices could encourage litigation.

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### Changing Acreages and Issuing Lease Corrections

Information related to mineral tracts under the management of the Department is maintained in a database. A large amount of information related to tracts is maintained including legal descriptions of the tracts, acreage amounts, trusts, etc. Due to various reasons, such as land survey results, acreage amounts within the database are updated or changed. We identified a lack of monitoring of changes being made to the information in the database. For example, no process has been established for reconciling acreage changes in the minerals database. Errors in updating information or unapproved changes to information could occur without management's knowledge.

The Department's procedure was to amend an oil and gas lease when changes to acreages occur with a tract. In a limited review of information in the minerals database, we identified instances of changes to acreages without a corresponding amendment to the oil and gas lease.

### Recommendation 1-7

We recommend the Department of Trust Lands:

- a) Monitor changes made to information in the minerals database to ensure changes are appropriate and adequately documented.
- b) Ensure lease agreements are appropriately updated when changes occur.

### Management's Response

The Department agrees with the recommendations. The Department will work to ensure that existing procedures are followed and will implement reconciliation procedures and training related to data changes. The

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## Chapter 1 Surface and Mineral Areas

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Department will take measures to appropriately update lease agreements when changes occur.

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### Ensuring a Fair Market Return

According to the Department's website:

"The Surface Management Division leases and manages surface acres held in trust for various schools and institutions. The major source of income on these lands comes from grazing and agricultural leases, with significant revenue also being generated from rights-of-way, salt water disposal, and gravel and scoria mining. The objective of surface management is to obtain a fair market return from the lands while maintaining or improving their condition and value."

In review of information related to leases for grazing, we conclude pasturelands were being leased at below market values. In 1989, the method of calculating minimum opening bids was approved by the Land Board. The Land Board was made aware the opening bids taken to public auction would be below market value. Also, the Land Board was informed over 80% of the school lands received no competitive bidding.

We identified the method for establishing minimum bids on trust lands still results in opening bids being below market value when compared to the North Dakota County Rents and Values Annual Survey (adjusted for fencing allowance provided by the Department). In addition, over 85% of pastureland tracts related to active leases were leased at the minimum opening bid amounts without competition (based on the Department's data). Establishing more reasonable minimum opening bids would meet the objective of obtaining a fair market return on the land and maximizing lease revenue will benefit the trusts assigned to the land. Examples of potential changes in establishing minimum opening bids include:

**The Department does not appear to be obtaining a fair market return for grazing leases of pastureland.**

- Using county averages rather than regional averages: The Department's method for calculating the minimum opening bids for pastureland was based on the 5 year moving average of the lowest county rent in each leasing region (counties with similar landscape, soils, vegetation, and rentals are grouped into regions).
- Eliminating/reducing the survey error: The Department's method for calculating the minimum opening bids for pastureland was based on information from the County Rents and Value survey, conducted by the North Dakota Field Office of USDA's National Agricultural Statistics Service. The Department reduced the amounts identified by 10% for a survey error adjustment (reduced in 1998 from 20% after the Department determined the survey was statistically valid).
- Using an inflationary factor: The method for calculating the minimum opening bids for pastureland has no inflation factor. The Department

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## Chapter 1 Surface and Mineral Areas

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used a 5 year average in calculating the minimum opening bids and entered into 5 year leases for pastureland.

The Department attempts to set minimum opening bids and allow competition at the auction to establish the market value. However, due to limited, to no, competition on the majority of pastureland tracts, the Department does not appear to be obtaining a fair market return from the lands.

### Recommendation 1-8

We recommend the Department of Trust Lands ensure the minimum opening bids for pastureland result in a “fair market” return.

### Management’s Response

The Department agrees with this recommendation. See Appendix C for the Department’s complete response.

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## Reviewing the Use of Online Auctions

Historically, the Department has conducted oil and gas auctions in a live, public auction setting. In July 2015, the Department used an online auction for auctioning certain tracts. We compared the bonuses received from the online auction to bonuses received at live auctions for similarly located tracts. It appeared the online auction generated higher bonuses. However, the results of one online auction is not considered sufficient to base a final conclusion. While the Department was comparing information related to online versus live auctions, the comparison did not include differences in costs associated with each auction. We conclude the online auction would require less resources to be expended compared to the live auction.

### Recommendation 1-9

We recommend the Department of Trust Lands:

- a) Analyze the use of additional online auctions, including costs associated with online versus live auctions.
- b) Use the auction process determined to be more beneficial to the trusts.

### Management’s Response

The Department agrees with these recommendations. The Department has used an online mineral auction service provider since 2011, most often when leases needed to be offered between quarterly scheduled live auctions. In August 2015 and February 2016, the Department conducted a comparison of live and online oil and gas lease auctions with inconclusive results. The Department will continue this analysis and determine the auction method most beneficial for the trusts.

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## Monitoring Surface Tracts

The Department’s Surface Management Division has established a policy to perform an on-site integrity inspection of each surface tract at least once every 5 years. We selected 10 tracts to review information related to inspections. Two tracts were included in federal natural grasslands. The leases for the two tracts are entered into with grazing associations. Rather

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## Chapter 1 Surface and Mineral Areas

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than conduct integrity inspections, the Department relies on the grazing associations and the federal government to ensure the state owned tracts are used responsibly and in accordance with established requirements. However, the Department has no agreement established related to inspections being conducted and has no assurance adequate inspections are performed. Also, violations or concerns identified in inspections may not be communicated to the Department.

Of the remaining 8 tracts, the Department had performed an inspection at least once every 5 years. The inspections on two of the tracts included information related to issues/violations (overgrazing and noxious weeds). However, the Department did not appear to notify the lessees of the concerns and/or require the lessees to take corrective actions.

**Violations of lease provisions are not adequately followed up on by the Department.**

The Department's policy is to establish an improvement plan when a violation is noted in an inspection of a surface tract. The establishment of an improvement plan will typically result in an annual inspection of the land. However, we identified for certain violations, such as a trash violation, the Department will not conduct an inspection until the regularly scheduled integrity inspection (possibly up to 5 years later). The Department will only contact the lessee and inform the lessee the violation needs to be corrected. We selected 5 tracts with improvement plans and reviewed information related to the actions taken by the Department. Two of the improvement plans related to feeding or hay storage violations (lessees may not feed animals on state tracts and may not store hay from other property on a state tract). While the Department performed an inspection the subsequent year on one of the tracts, the Department waited two years to perform an inspection on the other tract. Even after waiting two years, the inspection identified the same issue still existed. However, no additional follow-up was conducted by the Department.

When the Department identified trash violations with leases (old equipment, hunting blinds, etc.), we conclude the actions taken by the Department were not adequate. If a violation occurred and a lease had expired without the violation being corrected, the Department would add a provision to the new lease requiring corrective action within 6 months. It appears the Department would not follow up to ensure corrective action was taken in 6 months. Requiring corrective actions to be taken in new leases could have a negative impact on the amount received at auction.

### **Recommendation 1-10**

We recommend the Department of Trust Lands ensure:

- a) Agreements are entered into and/or information is obtained for inspections not conducted by the Department on state owned tracts.
- b) Appropriate action is taken when violations or other concerns are identified on surface tracts.

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**Management's Response**

The Department agrees with these recommendations. See Appendix C for the Department's complete response.

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**Classifying State Land**

NDCC Section 15-02-05.1 states:

"In all cases under section 54-01-05.5 involving legislative bills dealing with the sale or exchange of state land, the commissioner of university and school lands shall provide the legislative assembly with an opinion as to whether the sale or exchange in question is consistent with the highest and best use of the land involved. As an aid in making the determination, the commissioner shall classify all land owned by the state or its instrumentalities according to its highest and best use. As used in this section, "highest and best use" means that use of a parcel of land which will most likely produce the greatest benefit to the state and its inhabitants, and which will best meet the needs of the people. In making this determination, the considerations of the commissioner shall include soils capability, vegetation, wildlife use, mineral characteristics, public use, recreational use, commercial or industrial use, aesthetic values, cultural values, surrounding land use, nearness to expanding urban areas, and any other resource, zoning, or planning information relevant to the determination."

The state law requirement for classifying land according to its highest and best use has been in effect since 1977. The Commissioner stated the Department does not have, nor has it ever conducted, a classification of all land according to its highest and best use. The Commissioner stated conducting the classification activity would necessitate general or special funding and this has not been appropriated by the Legislature.

**Recommendation 1-11**

We recommend the Department of Trust Lands either:

- a) Comply with the North Dakota Century Code requirement related to classifying all land owned by the State or its instrumentalities according to its highest and best use; or
- b) Take appropriate action to modify the requirement of classifying all land owned by the State or its instrumentalities.

**Management's Response**

The Department disagrees with recommendation "a)", as it has complied with state law. The Department agrees with recommendation "b)" and will request that the legislature modify the law to minimize confusion or to remove the little used statute entirely.

In context with NDCC § 54-01-05.5, NDCC § 15-02-05.1 requires the Commissioner's review when the sale of state land is contemplated by the legislature. Legislative proposals to sell land have historically exempted the application of NDCC § 15-02-05.1. The Department does not have, nor has it ever conducted a classification of all land owned by the State or its instrumentalities. These statutes require an assessment of a tract's highest and best use only when the legislature is considering a measure

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that involves the sale or exchange of state land and do not require that an assessment be done on ALL state land. Recognizing that the phrasing within NDCC § 15-02-05.1 can be construed in more than one way; the Department will seek affirmation from legal counsel that it has correctly interpreted this law.

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## Financial Areas

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### Introduction

Significant improvements needed by the Department of Trust Lands (Department) related to financial areas are included in this chapter. Improvements of less significance were communicated in a separate letter to management of the Department. To conduct a review of financial areas, we:

- Reviewed applicable laws and policies.
- Reviewed a selection of expenditures.
- Reviewed how expenditures were allocated to trusts, programs, and activities.
- Reviewed information related to investments.
- Interviewed selected personnel.

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### Improving Accountability

Throughout the work performed in relation to the audit objective addressed in this report, we identified issues relating to the Department not fulfilling fiduciary responsibilities, public funds being used in an inappropriate manner, and a lack of an organizational culture of accountability. Examples of issues include:

#### Trusts Assigned to Tracts

The tracts of land managed by the Department are assigned to trusts. The Department has a responsibility to ensure the right trust has been assigned to a tract. In Chapter 1, we identify concerns related to the wrong trusts being assigned to tracts. This has negatively impacted the net assets of certain trusts as well as having adverse effects on distributions to beneficiaries of trusts.

In 2011, a review of information related to the assignment of trusts to tracts had been performed by the former Director of Revenue Compliance. While the review identified a number of potential issues with trusts assigned to tracts being incorrect, the Department did not take actions necessary to confirm and/or correct the problem. The Commissioner had been aware the potential for issues could exist with the trusts assigned to tracts. However, the Commissioner was not provided specific instances of actual problems. When asked for reasons why no action was taken with the potential issues, the Commissioner stated “if it comes down to why wasn’t this addressed at the time, bottom line is there was greater priorities of greater magnitude and limited resource to try and address them.”

**While the Department was aware of the potential for issues existing with trusts assigned to tracts, other priorities and limited resources appeared to have prevented appropriate actions from being taken.**

#### Royalty Payments

In Chapter 1, various areas requiring improvements related to oil and gas royalty payments are identified. The Department had not ensured revenue a trust was entitled to had, in fact, been credited to the trust. The Department had allocated royalty payments to wrong trusts and had limited assurance royalty payments received were correct. This has

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## Chapter 2 Financial Areas

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negatively impacted the net assets of certain trusts as well as having adverse effects on distributions to beneficiaries of trusts.

**The Department had not ensured revenue a trust was entitled to had, in fact, been credited to the trust.**

In certain instances, the Department was aware of potential issues impacting royalty payments. While potential issues with royalty payments were identified, the Department did not take actions necessary to confirm and/or correct the problems. For example, the Department had generated a list of potential concerns related to decimal interest numbers reported by operators and the decimal interest numbers calculated by the Department. However, limited resources were dedicated to complete the necessary reviews required. We identified certain royalty payments received by the Department appeared incorrect due to the wrong decimal interests being used by operators. Also, while the Department made changes to acreage amounts, proper changes were not made to payment codes used to allocate royalty payments.

### Interactions with Vendors

We identified a common practice of the Department was to allow certain employees to accept free meals and drinks (including alcoholic beverages) from investment entities under contract. This included Department employees taking spouses to social meetings with and paid by representatives of investment entities. However, while it was a common practice, we identified the Department made an apparent change to the acceptance of free meals and drinks. In an email exchange in June 2015, the Commissioner was asked how to handle investment representatives wanting to have dinner with spouses. The Commissioner replied “You know with the conversation with the northern guys and the auditors in house.- let’s not, it is nice to visit with them. But my paranoia has reached a new level.” In a follow-up email, the Commissioner provides an alternative to meet at a local restaurant and have everyone buy their own meal.

**The Department’s common practice of accepting free meals and drinks from investment entities changed when the audit was conducted.**

### Reimbursement for Meals

In reviews performed on selected expenditure transactions, we identified instances of employees being paid for meal per diems when a contractor had provided the employees the meal being claimed. For example, an employee visited two money managers in California to perform a “due diligence” review. The employee went out with the money managers for various meals and the money managers paid for the meals. One of the money managers paid for a dinner one day and lunch the following day. The other money manager paid for a dinner. The Department paid the employee the per diem amount for all three meals the money managers had already paid.

We identified the Department appeared to change the practice of allowing employees to claim per diem for meals provided by contracted investment

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### Financial Areas

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firms. For example, the Department had a contract with a consultant based in Chicago to provide investment services, including assistance in the selection of money managers. In April and September of 2014, Department employees were in Chicago to conduct interviews of potential money managers. The employees were provided meals by the investment consultant. The employees also claimed and were paid the meal per diem. Department employees also went to Chicago in October 2014 and February 2015 for interviews of money managers. During these visits, the employees were again provided meals, however, the employees did not claim the meal per diem for the meals provided. The motion by the Legislative Audit and Fiscal Review Committee for a performance audit to be conducted of the Department was passed on October 2, 2014, prior to the October 2014 trip to Chicago.

#### Use of Funds

In reviews performed on selected expenditure transactions, we identified concerns related to the principles of proper stewardship of public funds not being followed. Examples include:

- Two employees received a quarterly meal reimbursement when the meal was included in the registration fee of a conference. When meals are included in the cost of registration fees, the applicable quarterly meal allowance is not to be claimed according to state law.
- We identified costs were incurred for Department employees to perform on-site due diligence visits of money managers under contract. We question the reasonableness of such costs and identified limited value being added to what should be an effective review of a money managers' performance. For example, an employee visited two money managers in California. One of the money managers had been used by the Department for over 20 years and had already been visited by a previous Commissioner. Based on the amount of time available to conduct a visit and the lack of documentation related to what the visit entailed and/or considered, it appears limited value is added to the monitoring of money managers. Given today's technology capabilities, less expensive means exist for such "due diligence" reviews to be performed.
- The Land Board passed a motion authorizing the Commissioner to undertake a due diligence review, and subsequently negotiate with a money manager team in Columbus, Ohio for the possible hiring of the team to manage a new, \$100 million intermediate bond portfolio. A Department employee conducted an on-site visit of the money manager. Given the short notice to book a flight, the airfare was unreasonably high (over \$1,300). Based on scheduled flight times, the employee appeared to have been scheduled to be in Ohio for approximately 20 hours (arrive at 7:15 PM and depart at 3:20 PM the next day). The money manager considered for selection is a well-

**Public funds were not used as efficiently and effectively as they could have been.**

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## Chapter 2 Financial Areas

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known, established entity. There appears to have been little value added to determine whether the money manager was doing a good job given the limited time on-site and the fact significant history and current analysis of the financials and business model were available. The employee conducting the visit was taken to dinner by the money manager (paid for by the money manager). The employee claimed, and was paid, the meal per diem for the dinner.

- A Department policy allowed certain employees to use their personal utility terrain vehicle (UTV) and/or all terrain vehicle (ATV). The policy included reimbursement on a monthly basis (\$360/month) for certain months and a daily basis (\$60/day) for other months. We identified an employee being reimbursed the monthly amount for two consecutive months even though the employee only used their UTV once each month.
- The Department was in noncompliance with procurement laws and policies (additional information included in a subsequent section).
- The Department used public funds to purchase a Keurig coffee maker for employees to use. We also identified a refrigerator and dishwasher were purchased using public funds.
- The Department provided legislative general salary increases in noncompliance with Session Law requirements. Also, the Department provided certain salary increases in noncompliance with administrative rules.

### Conclusion

The Department has fiduciary responsibilities to ensure revenues trusts are entitled to are received and trust moneys are used in an efficient and effective manner. We identified the Department appears to have changed practices once the performance audit was to be conducted. According to the Government Accountability Office's *Standards for Internal Control in the Federal Government* (dated September 2014), management enforces accountability of individuals. The standards state "Accountability is driven by the tone at the top and supported by the commitment to integrity and ethical values, organizational structure, and expectations of competence, which influence the control culture of the entity." We conclude changes are necessary to ensure proper accountability exists within the Department.

The Department is not fulfilling fiduciary responsibilities and there is a lack of an organizational culture of accountability.

### **Recommendation 2-1**

We recommend the Department of Trust Lands:

- a) Ensure fiduciary responsibilities are fulfilled.
- b) Ensure public funds are used in an appropriate manner.
- c) Enhance the organizational culture of accountability.

### **Management's Response**

The Department agrees with the recommendations as provided. See Appendix D for the Department's complete response.

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## Chapter 2 Financial Areas

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### State Auditor's Concluding Remarks

See Appendix D for State Auditor's concluding remarks.

### Making Improvements with Purchasing and Contracting

As part of the review of selected expenditures, we reviewed compliance with procurement requirements included in state laws, rules, and policies established by the State Procurement Office. We identified improvements are needed to comply with procurement requirements. We also reviewed guidance included in the Office of Attorney General's "Contract Drafting and Review Manual" and the Risk Management Division's manuals to evaluate contracts entered into by the Department. We identified improvements could be made when entering into agreements with vendors.

### *Complying with Procurement Requirements*

We identified the Department was in noncompliance with various procurement requirements. In certain instances, the Department was not allowing for open and fair competition in the procurement process. This can result in not obtaining the best price possible. Examples of noncompliance include:

- The Department did not obtain required quotes when procuring certain commodities and services. State agencies are required to obtain informal bids or proposals for purchases over \$2,500 and under \$25,000. We identified the Department obtained no quotes in purchasing tables and chairs costing approximately \$4,000. Also, the Department obtained no quotes for services costing in excess of \$2,500 each fiscal year of the audit time period.
- The Department did not use a mandatory state contract when purchasing computer/technology equipment.
- The Department allowed multiple employees to procure commodities and services without having the required level of procurement training.
- The Department did not document the procurement process for selecting survey services as required by state law.

### Recommendation 2-2

We recommend the Department of Trust Lands ensure compliance with state procurement laws, rules, and policies.

### Management's Response

The Department agrees with this recommendation. The Department has implemented improvements to its procurement procedures by centralizing procurement oversight to one staff person and establishing a purchasing approval policy. Many of identified examples of noncompliance occurred prior to these improvements. The Department will continue to improve on these processes by reviewing procurement processes for all contracts and purchases.

### *Improving Contracting*

As part of this performance audit, we reviewed contracts the Department entered into and determined whether applicable terms and conditions were included. We identified improvements are needed to establish formal

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## Chapter 2 Financial Areas

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Certain agreements lack appropriate terms and conditions to adequately address risks.

agreements, reduce risks, and ensure the state's best interests are adequately protected. Examples include:

- **Written agreements:** The Office of Attorney General guidance states once an agency determines goods or services are needed, the agency must develop a written agreement identifying terms and conditions. The Department made payments to vendors and had very limited, to no, written agreement or contract. For example, the Department made a payment of \$18,000 for legal services without a written agreement.
- **Insurance provisions:** Certain agreements reviewed did not contain provisions for insurance requirements of lessees for apparent high risk activities. For example, the template agreement used for saltwater disposal easements does not contain insurance clauses or require proof of pollution liability coverage.
- **Contract terms and conditions:** The Office of Attorney General guidance includes applicable terms and conditions agreements should contain. Certain agreements we reviewed did not include terms and conditions recommended. In addition, while the template agreement for a lease includes a provision for compensating the Department for losses suffered due to fire or contamination, templates for saltwater disposal wells and oil and gas wells do not include such compensation language.
- **Legal reviews:** The Department was asked to provide information related to legal counsel reviewing certain agreements. The Department was unable to identify information related to reviews being performed by legal counsel or was unable to identify the date of last review on certain agreement templates.

### Recommendation 2-3

We recommend the Department of Trust Lands:

- a) Ensure payments for services are made pursuant to a written contract or agreement.
- b) Perform a risk analysis for all contracts and agreements to ensure appropriate insurance provisions are included.
- c) Include applicable terms and conditions within contracts and agreements as recommended by the Office of the Attorney General.
- d) Ensure appropriate reviews are performed by legal counsel.

### Management's Response

The Department agrees with these recommendations. The Department will take steps to improve contract management processes as outlined in the recommendations. A review of existing written agreements and templates will be undertaken to verify that they have been reviewed by legal counsel and include appropriate risk management provisions.

With respect to recommendation that payments for services are made pursuant to written contracts or agreements, the auditors cite an example of a payment of \$18,000 for legal services not included within a written agreement. According to NDCC §54-12-08 the Department is barred from

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## Chapter 2 Financial Areas

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contracting for legal services. Rather, the authority to appoint a Special Assistant Attorney General lies solely with the Attorney General. The Department's role in the appointment of a SAAG is consultative. The appointment of a SAAG must be in writing, thus the agreement for legal services is retained by the Attorney General's office.

### State Auditor's Concluding Remarks

While the Department agrees with the recommendation, the Department believes it is barred from contracting for legal services. Since the Department never brought this concern to us during the audit or once a draft copy of the report was provided, we were unable to inform the Department of this inappropriate determination. The Department appears to not understand the requirements within NDCC Section 54-12-08. The sections states an agency may not employ legal counsel except upon written appointment by the Attorney General. The written appointment would relate to the Attorney General exercising the authority to appoint an assistant or special assistant attorney general to represent the state. The written appointment would not contain other contract terms and conditions, including compensation, as this is the agency's responsibility (this was confirmed with a representative of the Office of the Attorney General).

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### Making Improvements with Accounting

Based on a review of accounting information, we conclude the Department has not properly allocated certain expenses to the appropriate trusts, programs, and/or activities. As a result, certain trusts have paid expenses not associated with the particular trust. According to the North Dakota Constitution, the costs of administering a perpetual trust fund may be paid out of the fund. However, no part of the common schools and the educational or charitable institution's trust funds are to ever be diverted, even temporarily, from the purposes established by the Constitution.

The "State Lands Maintenance Fund" is a fund within ConnectND (state's accounting system). State law requires all administrative salaries and operating expenses of the Department to be paid from the maintenance fund. The Department uses a number of formulas to determine amounts to transfer from the various trusts into the maintenance fund.

In review of information, we identified certain changes with the accounting of expenses were necessary. For example:

- After expenses have been paid out of the maintenance fund, the Department attempts to identify directly related costs associated with the trusts, programs, and/or activities. Adjusting entries are completed to reallocate directly related costs. However, certain directly related expenses were not being properly identified in the Department's review. For example, unclaimed property collection fees are paid from the maintenance fund.
- The formula used by the Department to transfer moneys into the maintenance fund does not take into account costs associated with administering the Indian Cultural Education Trust (established in

**Certain trusts have paid expenses not associated with the particular trust.**

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2003). It appears the Department has allocated no expenses to the trust even though expenses have been incurred. For example, the Department provides annual reports to beneficiaries.

- The Department developed a formula to use to allocate rent costs to trusts and other programs. However, the formula had an error. As a result, the Energy Infrastructure and Impact Office was overcharged. In addition, the Department had made the decision to not charge the Unclaimed Property Program rent claiming the Common Schools are a beneficiary of the activity (Unclaimed Property funds are credited to the Common Schools trust). We conclude this is inappropriate as the Common Schools trust, in effect, is paying the rent for the Unclaimed Property program.

### Recommendation 2-4

We recommend the Department of Trust Lands:

- a) Ensure direct costs are applied to the appropriate trust, program, and/or activity.
- b) Ensure non-direct costs are allocated in an appropriate manner to trusts, programs, and activities.

### Management's Response

The Department agrees with these recommendations. The State Lands Maintenance fund is created under authority of NDCC § 15-03-01.1 to fund Department operations. It consists of fees charged for services, plus a portion of the trusts' financial assets. Due to the multi-functional nature of the Department, a review of the allocation of direct and indirect costs will be completed to identify appropriate changes.

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## Conducting a Fraud Risk Assessment

The Government Accountability Office's *Standards for Internal Control in the Federal Government* (dated September 2014) provides criteria for designing, implementing, and operating an effective internal control system. The principles within the Risk Assessment section state management should:

- Define objectives clearly to enable the identification of risks.
- Define risk tolerances, identify, analyze, and respond to risks related to achieving the defined objectives.
- Consider the potential for fraud when identifying, analyzing, and responding to risk.
- Identify, analyze, and respond to significant changes that could impact the internal control system.

The Office of Management and Budget (OMB) Policy 216 requires all agencies to perform a fraud risk assessment for each function and division at least every biennium. We identified no fraud risk assessment documentation applicable to the OMB policy requirement. Fraud risk assessments should identify potential schemes and events needing to be mitigated, identify where fraud may occur and who the perpetrators might be, and anticipate the behavior of a potential fraud perpetrator. The lack

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of a fraud risk assessment being completed periodically reduces the Department's ability to properly address potential risks.

### Recommendation 2-5

We recommend the Department of Trust Lands conduct a formal fraud risk assessment as required by the Office of Management and Budget policy.

### Management's Response

The Department agrees with this recommendation. The Department will work to complete a fraud risk assessment each biennium as outlined in OMB Fiscal Policies.

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## Complying with the Code of Ethics

The Department's Code of Ethics policy states, in part, employees are to "avoid any action which would result in or might create the appearance of" giving preferential treatment to any business or person, losing independence or impartiality, or creating an adverse effect to the integrity of the Land Board or Department. The Code of Ethics has been approved by the Land Board. We identified instances of apparent noncompliance with the policy.

Employees' actions have created an appearance of losing independence or impartiality.

The Department has a number of agreements with various money managers, investment companies, etc. We identified the Commissioner and Department investment employees were willingly accepting free meals and drinks (including alcoholic beverages) from representatives of the investment entities. The meals and drinks were provided both when investment entities were in Bismarck and also occurred when employees traveled to investment entities out of state to conduct due diligence reviews. In addition, Department employees would take spouses with to social meetings with, and paid by, representatives of investment entities. Based on a review of emails provided by the Department and interviews with employees, we conclude the Department was attempting to form personal relationships with representatives of investment entities.

In addition to accepting free meals and drinks from entities under contract with the Department, we also identified an employee accepted a meal from a money manager being considered for selection. The money manager was selected to perform investment services for the Department.

We identify a very limited, to no, government business purpose being served by forming personal relationships with entities Department employees should be independently and objectively evaluating. The acceptance of free items from vendors and forming personal relationships may affect the ability of the Department to independently and impartially evaluate vendors. We conclude employees' actions have created an appearance of losing independence or impartiality.

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### Recommendation 2-6

We recommend the Department of Trust Lands avoid actions resulting in or creating the appearance of:

- a) Losing independence or impartiality.
- b) Creating an adverse effect on the integrity of the Land Board or Department.

### Management's Response

The Department agrees with these recommendations. The Department staff follow the Board adopted Code of Ethics policy regarding employee interaction with members of the public. All dealings with existing and prospective contractors follow this policy, which precludes acceptance of "anything of value" in excess of \$100 annually. As fiduciaries, the Department oversees investment responsibilities and recommended Board decisions that are in the best interests of the trust funds under its control. The Board will be asked to review its Code of Ethics policy.

### State Auditor's Concluding Remarks

While the Department agrees with the recommendation, the Department clearly believes it is complying with the Code of Ethics policy. The Department's response attempts to mislead readers by stating all dealings with existing and prospective contractors follow the \$100 threshold policy. We do not state in the report whether the items inappropriately received by employees were in excess of \$100 annually. Based on reviews of information, including an email from an employee to an investment firm representative to "put you on the beer calendar and can add you to the work calendar if needed," and discussions with employees, we would conclude the actions of employees have resulted in noncompliance with the Code of Ethics policy.

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### Information Related to Using the State Investment Board for Investments

The State Investment Board (SIB) has statutory responsibilities for the administration of investment programs of several funds, including the Public Employees Retirement System (PERS), Teachers' Fund for Retirement (TFFR), and the Legacy Fund. SIB has the statutory authority to provide investment services to, and manage the money of, any agency, institution, or political subdivision of the state. The Retirement and Investment Office (RIO) is responsible for carrying out SIB responsibilities.

The Land Board has statutory responsibilities related to the control of investments of the permanent funds. The Land Department has established an Investment Division. The division is responsible for directing, implementing, and monitoring the Land Board's investment program. In a review of information relating to the Department's investment function and comparison to SIB, it appears advantages may be gained by utilizing SIB for investment of Department controlled trust assets.

In October 2011, the Commissioner addressed concerns regarding investments to the Land Board. According to meeting minutes:

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## Chapter 2 Financial Areas

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- The Commissioner addressed the fact the Department does not have the tools to perform investment functions as effectively or efficiently as an investment consulting firm.
- The Commissioner stated since so much has changed, the Land Board should consider outside, independent investment advice to help manage and monitor the investment portfolio.
- The Commissioner presented three investment options – seek assistance from money managers, hire an independent investment consultant, or outsource all or part of the investment program.

The Land Board directed actions be taken for a complete reevaluation of the investment program. A contract was entered into by the Department for an investment study in 2013. Since the hiring of the consultant for the investment study, the Department has utilized the same consultant for implementing a new asset allocation, money manager searches, and performance reporting. The new asset allocation recommended by the consultant, and approved by the Land Board, includes riskier investments covering a broader range of asset classes (in prior years, the Department appeared to have been invested mainly in low risk, passive investments). With the change in asset allocation and the resulting changes in operations, we conclude the Land Board and the Department are, in effect, performing functions similar to SIB and RIO.

In a comparison of personnel between the Department and RIO, it appears RIO has the more experienced and higher qualified individuals in the investment area. RIO employs at least four individuals working with investments compared to two investment-related employees at the Department. The Chief Investment Officer (CIO) and Deputy CIO at RIO share over 45 years of investment related experience. The employees in the Investment Division include a certified public account with 30 years of experience with the Department and the Department's former information technology director. While the Department may have had the necessary experience to manage investments prior to the asset allocation change, it appears the Department may benefit from SIB's expertise to manage investments.

Through our review, it appears efficiencies may be realized by utilizing SIB for the Department's investments, including efficiencies in fees and investment services. Department and RIO representatives have worked together in an effort to receive fee discounts with money managers used by both agencies. However, additional savings may result if only one agency is negotiating fees with a money manager instead of two. When both SIB and the Department have the same money manager, each has incurred costs to select the money manager and, after hiring the money

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## Chapter 2 Financial Areas

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manager, both agencies are performing similar work in relation to monitoring (performance monitoring or reviewing fees charged).

**While advantages may exist to use SIB, the Land Board has recently determined to not use SIB.**

SIB was created to be the investment entity for certain public funds. An Attorney General's Opinion from 1994 does conclude the Land Board may contract with SIB as to the investments of various trusts under the management of the Land Board. In July 2015, the Land Board specifically made the determination to continue with its investment operations and not utilize SIB for investments. While we identify certain advantages may exist with using SIB and having state government have one investment board, the Land Board recently determined to not use SIB. With no significant changes potentially impacting or requiring the Land Board to reconsider this decision, it appears any recommendation from our office would not be considered productive.

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## Human Resource Areas

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### Introduction

Significant improvements needed by the Department of Trust Lands (Department) related to human resource areas are included in this chapter. Improvements of less significance were communicated in a separate letter to management of the Department. To conduct a review of human resource areas, we:

- Reviewed applicable laws and policies.
- Reviewed a selection of hires and promotions.
- Reviewed salary administration areas.
- Reviewed a selection of performance evaluations.
- Interviewed selected personnel.

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### Making Improvements with the Hiring Process

We reviewed information and conducted interviews of personnel related to how the Department hires employees. We made a selection of five employees hired during the audit time period and reviewed compliance with applicable laws, rules, and policies.

#### *Hiring Applicants who Meet Minimum Qualifications*

The Human Resource Management Services (HRMS) Division of the Office of Management and Budget (OMB) is responsible for establishing and maintaining a classification system for state agencies. North Dakota Administrative Code (NDAC) allows state agencies to hire employees into a position in the classified service provided the individuals at least meet the minimum qualifications of the position. For 2 of the 5 hires reviewed, the Department hired individuals not meeting the minimum qualifications of the position.

**An individual was hired even though the Department was aware the individual did not meet the minimum qualifications of the position.**

In the hiring of an Information Technology Director position, the Department apparently disregarded the minimum qualification requirement and hired an individual the Department was aware did not meet the minimum qualifications of the position. While the position being filled required a bachelor's degree and a certain number of years of experience, the Department hired an individual who did not have a bachelor's degree. Also, the selected individual was hired at a salary rate above the first half of the salary range. The Department was required by administrative rules to receive approval from HRMS to pay this salary rate. The request from the Commissioner included a statement regarding the five applications received, "only two candidates met the expected qualifications and were interviewed." The individual selected clearly did not meet the qualifications of the position.

In the hiring of a Mineral Title Specialist position, the Department selected an individual who did not meet the minimum qualifications of the position. The minimum qualifications required four years of work experience in duties related to mineral or land management practices. The selected individual only had three years of the required work experience. The Department appears to have included other work experience not

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## Chapter 3 Human Resource Areas

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applicable to the minimum qualifications in calculating the years of work experience.

### Recommendation 3-1

We recommend the Department of Trust Lands ensure individuals hired into classified, nontemporary positions meet the minimum qualifications for the job class as required by North Dakota Administrative Code.

### Management's Response

The Department agrees with this recommendation. The Department will continue to work with the State's Human Resource Management Services Division to ensure compliance with system classification descriptions and grades.

### *Improving the Hiring Process*

HRMS provides information to state agencies related to the hiring process. The process highly recommended by HRMS includes a number of best practices for state agencies to follow. We identified the Department was not following certain best practices. For example, there was no predetermined number of applicants to forward to interviews, Department employees involved in screening applicants were also involved in interviews, and there were no rankings of interviews or a final ranking of applicants. There appears to be very limited, to no, training provided to employees involved in the hiring process.

The Department was not follow certain hiring process best practices.

Improvements were also needed with how points were being awarded in the screening process (evaluation of information submitted by applicants). For example, the Department awarded points in areas not addressed in the job announcement and awarded more points for an associate's degree compared to a bachelor's degree. Also, while a job announcement did not state imminent graduates could apply, the Department allowed an applicant graduating at a later date with the necessary degree to apply and be hired. The lack of an appropriate hiring process can increase risks associated with: not identifying the most suitable candidate for employment, noncompliance with laws and policies, and appeals of a hiring decision.

### Recommendation 3-2

We recommend the Department of Trust Lands:

- a) Follow Human Resource Management Services' hiring process best practices.
- b) Provide proper training to employees involved in the hiring process.

### Management's Response

The Department agrees with these recommendations. The Department will work with HRMS to ensure legal requirements of HRMS recruitment and hiring best practices are met. The Department's human resources manager will continue to participate in training appropriate to oversee hiring processes.

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## Chapter 3 Human Resource Areas

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### *Ensuring Compliance with Veterans' Preference Requirements*

North Dakota Century Code Chapter 37-19.1 establishes requirements to provide preference to veterans in the hiring process. Of the five hiring processes reviewed, one included an applicant who qualified for veterans' preference. We identified applicable preference points were not awarded on one of the application screening sheets for this individual. Also, there was no predetermined number of applicants to forward for interviews and there was no listing of applicants in rank order according to their screening score.

### **Recommendation 3-3**

We recommend the Department of Trust Lands comply with veterans' preference hiring requirements pursuant to North Dakota Century Code.

### **Management's Response**

The Department agrees with this recommendation. Since 2014 the Department has required job applicants to submit application materials through the State's Recruiting Solutions online program which helps ensure preference points are awarded to eligible candidates. Starting in 2015, the Department implemented the practice of predetermining the number of candidates to be interviewed prior to the ranking of applications.

### **State Auditor's Concluding Remarks**

The Department's response is misleading. While the Department's responses in Chapter 1 specifically identify when changes occurred or actions were taken, certain responses in Chapters 3 and 4 are vague. Changes identified by the Department in Chapter 1 provide the necessary information and context to users of the report (i.e. changes occurred after the audit time period and/or were a result of our audit work). No such information or context is provided by the Department in Chapters 3 and 4. The implementation of predetermining the number of candidates would have occurred after this issue was addressed to the Department.

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### **Complying with Legislative Intent for Authorized FTE Positions**

State agencies may make a request for additional full-time equivalent (FTE) positions during the budgeting process. When a request is made, a state agency will identify information related to the position including a position title and reason(s) for the requested increase. In our review of information, we conclude the Department received additional FTE positions and did not fill certain positions as presented to the Legislature in the budgeting process. Information related to the two instances follows.

- In the 2009 Legislative Session, the former Commissioner testified one of the three additional FTE positions in the Executive Budget recommendation was for the administration of the Energy Development and Impact Office (EDIO) with any free time available to be used in the minerals management area. The Department used the new FTE position to hire a Mineral Title Specialist. In the following Legislative Session, the Department again requested a position for administrative support for EDIO.
- In the 2013 Legislative Session, the Commissioner testified 2 of the 6.25 additional FTE positions in the Executive Budget recommendation were for a Soil and Natural Resource Management

**Additional FTE positions were not filled in a manner consistent with the testimony provided to the Legislature.**

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### Chapter 3 Human Resource Areas

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Specialist and an Accountant to serve the energy impact office accounting and office support functions. The Department indicated the two new FTE positions and an existing vacant position were filled by an Information Technology Director, Unclaimed Property Administrator, and Programmer Analyst II.

#### Recommendation 3-4

We recommend the Department of Trust Lands comply with legislative intent for use of authorized full-time equivalent positions.

#### Management's Response

The Department agrees with this recommendation. The Department will utilize FTEs as requested in budget preparation and testimony and according to legislative appropriation, however there are circumstances that require management to reevaluate and adjust staffing to align with changing needs and fiduciary responsibility to the trusts. The Department has not exceeded the number of FTEs nor the total appropriated salaries authorized in law.

#### State Auditor's Concluding Remarks

The Department's response is misleading. In the instances we identified, the Department never filled the positions as requested. Also, the Department's statement of not exceeding amounts authorized in law is irrelevant as the recommendation has nothing to do with exceeding amounts authorized.

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### Ensuring Compliance with Salary Administration Requirements

Certain salary increases provided to employees were not in compliance with administrative rules.

NDAC Chapter 4-07-02 establishes salary administration requirements related to positions classified by HRMS. In a review of salary information, we identified the Department was in noncompliance with certain requirements. Information related to the NDAC noncompliance issues follows.

- A state agency can provide a salary increase of up to 5% when an employee successfully completes the probationary period. The Department provided an employee a 10% increase upon completion of the probationary period.
- A state agency can provide a responsibility level or workload salary increase as long as the increase is not more than 20%, consideration on the effect of internal equity is given, and the change in responsibility or workload is documented and on file within the agency. The Department provided certain responsibility or workload increases without adequate documentation of the change in responsibility or workload.

#### Recommendation 3-5

We recommend the Department of Trust Lands comply with salary administration requirements pursuant to North Dakota Administrative Code.

#### Management's Response

The Department agrees with this recommendation but believes that clarification of the auditors' examples is necessary to put them into context. The Department and Board manage the largest surface and mineral asset

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## Chapter 3 Human Resource Areas

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holding in the state. During the 2011-2015 timeframe of the audit, it managed exponential increases in easement requests, mineral lease applications, approved drilling permits, producing wells, and numbers of financial transactions. Workload and responsibility increases were evident throughout all areas of the Department, and it attempted to document them in budget requests, legislative presentations, biennial reports, and in the Commissioner's compensation letters to employees. The 10% "probationary" increase was for the FTE solely assigned to the Energy Impact program. Perhaps the 10% probationary increase would have been more clearly stated as a 5% probationary increase and a 5% workload/responsibility increase. During this employee's 6-month probation, legislative changes significantly increased the workload for this position by appropriating an additional \$35 million for oil impacts; creating a new \$30 million flood impact program, and creating responsibility for supervision of temporary staff. The Department will take steps to provide additional documentation of future salary increases.

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### Making Improvements with Performance Evaluations

We selected 10 classified employees and reviewed information related to salary increases and performance evaluations. We identified noncompliance with session law requirements and administrative rules. Also, improvements are needed to improve the effectiveness of performance evaluations.

#### *Complying with Requirements for Performance Evaluations*

The 2011 and 2013 Session Laws included provisions for general compensation adjustments for classified employees. In both biennia, general increases were to be based on documented performance. For the 10 employees selected, a total of 35 general legislative salary increases were provided in the four years. Of the 35 increases, 19 were provided without the required performance evaluation being completed.

NDAC requires classified employees to receive annual performance evaluations. Of the 10 employees selected, 9 had not received evaluations on an annual basis during the audit time period.

### Recommendation 3-6

We recommend the Department of Trust Lands comply with:

- a) Session law requirements related to general legislative salary increases.
- b) North Dakota Administrative Code requirements related to annual employee performance evaluations.

### Management Response

The Department agrees with these recommendations. The Department will adhere to legislative guidelines on salary increases and follow administrative code related to annual employee performance evaluations. In 2015 all classified employees participated in a formal evaluation process.

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## Chapter 3 Human Resource Areas

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### *Establishing an Effective Evaluation Process*

The Department's performance evaluation form required employees to sign the form signifying agreement or disagreement with their supervisor's evaluation. Employees should not be required to sign an agreement or disagreement statement regarding the evaluation. State law provides an employee an opportunity to review information regarding performance prior to the information being placed in the personnel file. The employee is to acknowledge the employee has read the material by signing the information to be filed. However, the signature merely signifies the employee has read the material and does not indicate agreement with the content.

In review of the Department's performance evaluations, we identified inconsistencies related to the completion of and format of the evaluations. For example, while the standard performance evaluation form for the Department indicates the employee should be evaluated on each major documented duty/responsibility, evaluations were not done based on documented duties/responsibilities. In addition, certain performance evaluations lacked information regarding certain duties/responsibilities of the employee. Also, the rating system used could be improved as a reviewer was only given two options, satisfactory or unsatisfactory, to rate the employee's performance.

### **Recommendation 3-7**

We recommend the Department of Trust Lands establish an effective process for evaluating employees' performance.

### **Management Response**

The Department agrees with this recommendation. The Department will improve processes for evaluating employees' performance and will coordinate with state Human Resource Management Services to transition to PeopleSoft's online Talent Management module. This tool will provide more consistency and standardization in review processes. All Department supervisors attended HRMS-sponsored employee evaluation training in 2015.

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## Additional Areas Needing Improvement

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### Introduction

In addition to areas addressed in Chapters 1 through 3, we also identified significant improvements are needed by the Department of Trust Lands (Department) related to other areas of operations. Improvements of less significance were communicated in a separate letter to management of the Department.

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### Improving Information Technology Systems

The information systems are old and difficult to maintain.

As part of the work performed for this audit, a number of areas were identified related to the Department's apparent lack of appropriate information technology systems. The Department appears to have started to transition to electronic databases in the 1980's. The current systems are old, making them difficult to maintain, and tools used to maintain the systems are not supported or are obsolete. There is a lack of collaboration between the surface and minerals databases. Certain activities the Department attempts to perform are not automated in the systems. Employees are required to use aspects of multiple systems to complete job duties and a large number of spreadsheets have been created outside of the systems.

The Department was unable to provide an updated user manual. Thus, there appears to be limited guidance for employees to follow and to understand the capabilities of the systems. We identified certain fields in the databases may increase the efficiency or effectiveness of operations and monitoring. However, the fields were either no longer being used or had not been used.

### Recommendation 4-1

We recommend the Department of Trust Lands ensure:

- Appropriate information technology systems exist.
- User manuals are established.
- Systems are used to the fullest extent possible.

### Management's Response

The Department agrees with these recommendations. With assistance from the State Procurement Office and the State Information Technology Department, the Department began procuring business analysis services in early 2016. The project will identify areas of process improvement and recommend methods for leveraging technology updates to better utilize shared data, integrate stand-alone applications, and automate processes that are currently being managed using separate spreadsheets. The completion of the business analysis is expected to lead to a request for an appropriation to upgrade all Department IT systems, which will require the completion of user manuals. In the interim, the Department will work to better document current processes relating to existing applications.

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### Making Improvements with Policies and Procedures

Throughout the performance audit, we attempted to identify documented policies and procedures established by the Department. However, the Department has not formally established certain policies and procedures. We identified no standardized format for policies and procedures. The policies and procedures provided by the Department were a mixture of

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## Chapter 4

### Additional Areas Needing Improvement

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various policy formats, emails, memos, etc. The Department lacked a periodic review process to ensure policies are properly updated. When policies were updated, changes were made inconsistently. According to the Government Accountability Office's *Standards for Internal Control in the Federal Government* (dated September 2014), management documents in policies the internal control responsibilities of the organization.

Policies and procedures are not maintained in a centralized location.

We requested the Department provide a copy of all policies and procedures. It took over five weeks for the Department to provide the requested information. Even with the extended amount of time it took the Department to provide the requested information, we identified the Department did not provide all policies and procedures. Department policies and procedures are maintained individually by divisions as well as having policies and procedures on the Department's intranet. The information on the intranet was not all inclusive and was not updated. The Department attempted to require employees to review policies and procedures annually as part of the performance evaluation process (employees were to acknowledge existence of policies on the intranet). However, as identified in Chapter 3, annual performance evaluations were conducted on a limited number of employees. Also, since policies and procedures were located in various locations, it is unclear how employees were even aware certain policies and procedures existed.

#### Recommendation 4-2

We recommend the Department of Trust Lands:

- a) Establish formal policies and procedures.
- b) Use a standardized format for policies and procedures.
- c) Review policies and procedures periodically to ensure information is current and relevant.

#### Recommendation 4-3

We recommend the Department of Trust Lands:

- a) Ensure policies and procedures are available to all employees in a centralized location.
- b) Require all employees to periodically review Department policies and procedures and signify acknowledgement in writing.

#### Management's Response

The Department agrees with these recommendations. The Department will work to establish an improved methodology for adoption, updating, implementation and administration of formal policies and procedures. It will centralize the responsibility of policy and procedures maintenance to ensure information is easily accessible and relevant. The Department will implement a system that distinguishes between policies adopted by the Board and are implemented by rule; those approved by the Commissioner for documentation of Department level guidance; and those that detail procedures and division operations.

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## Chapter 4 Additional Areas Needing Improvement

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In 2012 and 2015 all employees signed policy acknowledgement statements. All new employees sign acknowledgements as part of orientation.

### State Auditor's Concluding Remarks

The Department was attempting to have employees acknowledge review of policies and procedures as part of the annual evaluation process. Since annual evaluations were not consistently completed, employees were not signing policy acknowledgement statements. It appears the acknowledgement in 2012 was outside the performance evaluation process. Due to the lack of centralization and the fact the Department needed five weeks to provide us policies and procedures, there is limited assurance employees even were aware what policies and procedures existed.

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### Improving Monitoring

Limited monitoring of procedures is performed.

According to the Government Accountability Office's *Standards for Internal Control in the Federal Government* (dated September 2014), management "should establish and operate monitoring activities to monitor the internal control system and evaluate the results." While the Department has established certain internal control procedures, there appeared to be limited monitoring conducted to ensure what was intended to be occurring had, in fact, occurred. For example, the Department's written procedures include a requirement to maintain a spreadsheet listing saltwater easements to track the date each payment was received. The procedure would assist the Department in identifying outstanding payments. No summary spreadsheet was maintained.

When Surface Management Division personnel enter information on a saltwater disposal well, an "annual payment" button was to be selected, if applicable. When selected, the Revenue Compliance Division was notified of the new well needing to be monitored. We identified an instance of the "annual payment" button not being selected. As a result, the division was provided no notification and was unaware the required monthly payments had not been received.

### Recommendation 4-4

We recommend the Department of Trust Lands perform ongoing monitoring of the design and operating effectiveness of the Department's internal control procedures.

### Management's Response

The Department agrees with this recommendation. The Department plans to develop a program similar to its oil and gas royalty system to better manage other revenues. It will work to improve its internal control policies and monitor compliance with the policies with periodic testing of both revenue and expenditure management.

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## Chapter 4 Additional Areas Needing Improvement

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### Utilizing State Archives

The Department maintains a large number of original documents and records related to land transactions. Examples include documents on land exchanges with the federal government, acquired lands, sales of land, loans, and patents. Certain records are maintained in the Department's physical office location while others are stored at a contracted, offsite storage facility. The State Historical Society's State Archives is the official repository of historic records and records of enduring value produced by state agencies. The Department may be able to utilize the services offered by State Archives and reduce, or eliminate, the costs of using an off-site storage facility. Also, State Archives may have the capabilities to provide a more suitable storage environment for old, historic documents.

### Recommendation 4-5

We recommend the Department of Trust Lands, in conjunction with representatives of State Archives, review records and:

- a) Identify permanently retained records and/or records with archival value.
- b) Transfer applicable records to State Archives.

### Management's Response

The Department agrees with these recommendations. The Department recognizes that it is the custodian of records of unique historic value. A review of agency retention terms and possible disposal and transfer options is scheduled for summer of 2016 and will be done in conjunction with a State ITD initiative to move FileNet records of archival value from agency object stores to a State Historical Society's object store.

## Audit and Background Information

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### Purpose and Authority of the Audit

The performance audit of the Department of Trust Lands was conducted by the Office of the State Auditor, pursuant to a motion passed by the Legislative Audit and Fiscal Review Committee. The performance audit was conducted pursuant to authority within North Dakota Century Code Chapter 54-10.

Performance audits are defined as engagements that provide assurance or conclusions based on an evaluation of sufficient, appropriate evidence against stated criteria, such as specific requirements, measures, or defined business practices. Performance audits provide objective analysis so management and those charged with governance and oversight can use the information to improve performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability. The purpose of this report is to provide our analysis, findings, and recommendations regarding our limited review of whether the Department is obtaining, accounting for, and using resources efficiently and effectively.

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### Background Information

In 1889, Congress passed the Enabling Act which provided land grants to the State of North Dakota for the support of the common schools as well as colleges, universities, the state capitol, and other public institutions. To manage the assets, Article IX of the North Dakota Constitution created the Board of University and School Lands, more commonly referred to as the Land Board. The Land Board is comprised of the Superintendent of Public Instruction, Governor, Attorney General, Secretary of State, and State Treasurer.

The Department of Trust Lands serves as the administrative agency of the Land Board. The primary responsibility of the Department is to manage the permanent educational trust funds and assets under the Land Board's control as outlined in the North Dakota Constitution. State law also provides the Department the responsibility for managing the Unclaimed Property Division and the Energy Infrastructure and Impact Office, as well as overseeing sovereign mineral acres and several other statutory funds.

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### Objective of the Audit

Three objectives were established for this performance audit. A separate audit report is being issued for each of the audit objectives. The objectives of this performance audit were:

“Is unclaimed property effectively administered?”

“Are Energy Infrastructure and Impact Office grants effectively administered?”

“Is the Department of Trust Lands obtaining, accounting for, and using resources efficiently and effectively?”

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## Chapter 5 Audit and Background Information

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### Scope and Methodology

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require 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. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Audit field work related to obtaining, accounting for, and using resources was conducted from the beginning of June 2015 to the middle of March 2016. The audit time period was July 1, 2011 to June 30, 2015. In certain instances, additional information was reviewed. This was done, in part, to identify certain current processes and historical information such as prior Land board minutes and documentation regarding land transactions.

As part of this audit, we evaluated controls surrounding compliance with significant laws, policies, and procedures. We gained an understanding of internal controls surrounding these areas. Deficiencies identified with internal controls determined to be significant are addressed in Chapters 1 through 4 of this audit report. Deficiencies of less significance were communicated in a separate letter to management of the Department of Trust Lands.

As part of completing the objective, we:

#### Surface and Minerals Areas

Reviewed Land Board meeting minutes, rules and policies; Session Laws; State laws; the Department's website, policies, and procedures; leases and agreements; surface and mineral tract records; surface and mineral auction, right of way, payment collection, and monitoring processes; Revenue Compliance Division responsibilities; and work performed by the former Director of Revenue Compliance related to the assignment of trusts to tracts. Observed agricultural and oil and gas lease auctions. Compared oil and gas lease bonuses received at live auctions to the bonuses received at an online auction. Performed analytical reviews and comparisons of surface and mineral data. Analyzed the results of the 2015 fall agricultural auctions and compared the results to the 2015 USDA Cash Rent and Land Value Survey information. Judgmentally selected and reviewed:

- 12 right of ways issued for compliance with payment requirements.
- 10 surface tracts and 5 right of ways issued for compliance with tract inspection requirements.
- 5 out of 145 surface tracts with improvement plans for compliance with the plans.
- 40 surface tracts for proper trust assignments. Compared the trust assigned to the surface tracts to the trust assigned to the corresponding mineral tracts. In addition, 20 tracts with the highest

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## Chapter 5

### Audit and Background Information

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lease bonus payments were selected out of 120 leased mineral tracts assigned to the YCC trust to test for proper trust assignments.

- 10 surface tract numbers without a corresponding mineral tract number for completeness of the mineral acres in the database.
- 10 tracts in sections 16 and 36 the Department was not claiming mineral interest for completeness of the mineral acres in the database.
- 10 late payments for proper penalty and interest assessments.
- 5 wells from a list generated by the Department of wells with potential decimal interest issues for proper operator payments.
- 18 wells from a list generated by the Department of wells with potential payment code issues for proper payment allocations.
- 5 wells with acreage changes made to participating mineral tracts in the Department's database to ensure changes were properly supported and lease corrections were issued.

#### Financial Areas

Reviewed Land Board meeting minutes; State laws; Administrative Code; the Office of Management and Budget's Fiscal and Administrative policies, State Procurement Manual, and Risk Management Manual; the Office of the Attorney General's Contract Drafting and Review Manual; leases and agreements commonly used by the Department; e-mail and calendar entries of certain employees; and Government Accountability Office's *Standards for Internal Control in the Federal Government*. Compared the Department's Code of Ethics to RIO's Code of Conduct/Ethics policy. Analyzed the Department's databases and ConnectND Financials Accounts Payable and General Ledger data. Judgmentally selected the following transactions to test compliance with applicable requirements:

- 40 out of 2,515 accounts payable vouchers (total of 4,817 vouchers and excluded certain transactions such as grant payments and transfers).
- 10 out of 1,402 purchase card transactions.
- 10 out of 1,304 general ledger expenditures related to miscellaneous refunds and agricultural weed control from the maintenance fund.

Reviewed The Northern Trust reports; a request for proposal for investment consulting services, the hired consultant's proposal, and related contracts; and the processes for transferring money. Analyzed the feasibility of utilizing the State Investment Board. Judgmentally selected and reviewed:

- 10 transfers (fiscal year 2015) related to the Department's cash management account for proper authorization and segregation of duties.
- 5 expenses paid from investments (fiscal years 2014 & 2015) related to the Department's cash management account for proper accounting.

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## Chapter 5 Audit and Background Information

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### Human Resources Areas

Reviewed Land Board meeting minutes; 2011 and 2013 Session Laws; State laws; Administrative Code; and Office of Management and Budget HRMS Division policies; and 2009-11, 2011-13, and 2013-15 budget documentation and agency testimony. Analyzed ConnectND HRMS payroll data. Consulted with representatives from the Office of the Secretary of State and Office of Management and Budget HRMS Division. Compared legislative intent for newly authorized full-time employees to actual positions filled. Judgmentally selected:

- 5 out of 17 new employees to test compliance with hiring requirements.
- 2 out of 9 employees having a change in position number and/or job code to review compliance with promotion requirements.
- 10 out of 33 employees receiving a salary increase to test compliance with performance evaluation and salary administration requirements.

### Other Areas

Reviewed the Department's intranet, policies and procedures, record's retention schedule, electronic databases, and certain tracking spreadsheets; State laws; Government Accountability Office's *Standards for Internal Control in the Federal Government*; and information on the State Historical Society's website related to State Archives. Observed the off-site storage facility used by the Department to store certain permanent records with archival value. Consulted with the State Archivist.

## List of Recommendations and Management Responses

The following information identifies each recommendation and our conclusion as to whether the Department agreed or disagreed with the recommendation. Due to apparent contradictory information in certain management responses, we made a determination as to whether management agreed or disagreed with recommendations taking into consideration the entirety of the response.

	<u>Recommendation</u>	<u>Agree</u>	<u>Not Agree</u>	<u>Mixed</u>
<b>1-1</b>	We recommend the Department of Trust Lands: a) Ensure tracts of land managed by the Department are assigned to the correct trust. b) Obtain guidance from legal counsel on correcting net assets and past distributions for trusts incorrectly assigned to tracts.	X		
<b>1-2</b>	We recommend the Department of Trust Lands: a) Conduct a formal review of oil and gas royalty payments to ensure amounts received were based on the correct decimal interest. b) Establish a periodic review to ensure operators are using the correct decimal interest.	X		
<b>1-3</b>	We recommend the Department of Trust Lands: a) Ensure oil and gas royalty payments are correctly allocated to the proper trusts. b) Obtain guidance from legal counsel on correcting net assets and past distributions for royalty payment allocation errors.	X		
<b>1-4</b>	We recommend the Department of Trust Lands: a) Ensure information submitted with oil and gas royalty payments is consistently obtained in an electronic format and includes all necessary information to adequately monitor payment amounts. b) Conduct audits of oil and gas operators submitting royalty payments to the Department.	X		
<b>1-5</b>	We recommend the Department of Trust Lands establish: a) An interest rate to be assessed on late oil and gas royalty payments. b) A policy identifying the circumstances under which interest will be assessed.		X	
<b>1-6</b>	We recommend the Department of Trust Lands ensure penalties are consistently assessed on late oil and gas royalty payments and calculations are accurate.		X	

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**Appendix A**  
**List of Recommendations and Management Responses**

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	<u>Recommendation</u>	<u>Agree</u>	<u>Not Agree</u>	<u>Mixed</u>
<b>1-7</b>	We recommend the Department of Trust Lands: a) Monitor changes made to information in the minerals database to ensure changes are appropriate and adequately documented. b) Ensure lease agreements are appropriately updated when changes occur.	X		
<b>1-8</b>	We recommend the Department of Trust Lands ensure the minimum opening bids for pastureland result in a “fair market” return.	X		
<b>1-9</b>	We recommend the Department of Trust Lands: a) Analyze the use of additional online auctions, including costs associated with online versus live auctions. b) Use the auction process determined to be more beneficial to the trusts.	X		
<b>1-10</b>	We recommend the Department of Trust Lands ensure: a) Agreements are entered into and/or information is obtained for inspections not conducted by the Department on state owned tracts. b) Appropriate action is taken when violations or other concerns are identified on surface tracts.	X		
<b>1-11</b>	We recommend the Department of Trust Lands either: a) Comply with the North Dakota Century Code requirement related to classifying all land owned by the State or its instrumentalities according to its highest and best use; or b) Take appropriate action to modify the requirement of classifying all land owned by the State or its instrumentalities.			X
<b>2-1</b>	We recommend the Department of Trust Lands: a) Ensure fiduciary responsibilities are fulfilled. b) Ensure public funds are used in an appropriate manner. c) Enhance the organizational culture of accountability.		X	
<b>2-2</b>	We recommend the Department of Trust Lands ensure compliance with state procurement laws, rules, and policies.	X		

**Appendix A**  
**List of Recommendations and Management Responses**

<u>Recommendation</u>	<u>Agree</u>	<u>Not Agree</u>	<u>Mixed</u>
<p><b>2-3</b> We recommend the Department of Trust Lands:</p> <p>a) Ensure payments for services are made pursuant to a written contract or agreement.</p> <p>b) Perform a risk analysis for all contracts and agreements to ensure appropriate insurance provisions are included.</p> <p>c) Include applicable terms and conditions within contracts and agreements as recommended by the Office of the Attorney General.</p> <p>d) Ensure appropriate reviews are performed by legal counsel.</p>	X		
<p><b>2-4</b> We recommend the Department of Trust Lands:</p> <p>a) Ensure direct costs are applied to the appropriate trust, program, and/or activity.</p> <p>b) Ensure non-direct costs are allocated in an appropriate manner to trusts, programs, and activities.</p>	X		
<p><b>2-5</b> We recommend the Department of Trust Lands conduct a formal fraud risk assessment as required by the Office of Management and Budget policy.</p>	X		
<p><b>2-6</b> We recommend the Department of Trust Lands avoid actions resulting in or creating the appearance of:</p> <p>a) Losing independence or impartiality.</p> <p>b) Creating an adverse effect on the integrity of the Land Board or Department.</p>		X	
<p><b>3-1</b> We recommend the Department of Trust Lands ensure individuals hired into classified, nontemporary positions meet the minimum qualifications for the job class as required by North Dakota Administrative Code.</p>	X		
<p><b>3-2</b> We recommend the Department of Trust Lands:</p> <p>a) Follow Human Resource Management Services' hiring process best practices.</p> <p>b) Provide proper training to employees involved in the hiring process.</p>	X		
<p><b>3-3</b> We recommend the Department of Trust Lands comply with veterans' preference hiring requirements pursuant to North Dakota Century Code.</p>	X		
<p><b>3-4</b> We recommend the Department of Trust Lands comply with legislative intent for use of authorized full-time equivalent positions.</p>			X

**Appendix A**  
**List of Recommendations and Management Responses**

	<u>Recommendation</u>	<u>Agree</u>	<u>Not Agree</u>	<u>Mixed</u>
3-5	We recommend the Department of Trust Lands comply with salary administration requirements pursuant to North Dakota Administrative Code.	<u>X</u>	<u>      </u>	<u>      </u>
3-6	We recommend the Department of Trust Lands comply with: a) Session law requirements related to general legislative salary increases. b) North Dakota Administrative Code requirements related to annual employee performance evaluations.	<u>X</u>	<u>      </u>	<u>      </u>
3-7	We recommend the Department of Trust Lands establish an effective process for evaluating employees' performance.	<u>X</u>	<u>      </u>	<u>      </u>
4-1	We recommend the Department of Trust Lands ensure: a) Appropriate information technology systems exist. b) User Manuals are established. c) Systems are used to the fullest extent possible.	<u>X</u>	<u>      </u>	<u>      </u>
4-2	We recommend the Department of Trust Lands: a) Establish formal policies and procedures. b) Use a standardized format for policies and procedures. c) Review policies and procedures periodically to ensure information is current and relevant.	<u>X</u>	<u>      </u>	<u>      </u>
4-3	We recommend the Department of Trust Lands: a) Ensure policies and procedures are available to all employees in a centralized location. b) Require all employees to periodically review Department policies and procedures and signify acknowledgement in writing.	<u>      </u>	<u>      </u>	<u>X</u>
4-4	We recommend the Department of Trust Lands perform ongoing monitoring of the design and operating effectiveness of the Department's internal control procedures.	<u>X</u>	<u>      </u>	<u>      </u>
4-5	We recommend the Department of Trust Lands, in conjunction with representatives of State Archives, review records and: a) Identify permanently retained records and/or records with archival value. b) Transfer applicable records to State Archives.	<u>X</u>	<u>      </u>	<u>      </u>
<b>Total</b>		<b><u>22</u></b>	<b><u>4</u></b>	<b><u>3</u></b>

## Tract and Trust Information

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Congress passed the Enabling Act of 1889 to "provide for the division of Dakota into two states, and to enable the people of North Dakota, South Dakota, Montana and Washington to form constitutions and state governments and to be admitted into the Union on an equal footing with the original States, and to make donations of public lands to such States." Section 10 of the Act granted sections 16 and 36 in every township to North Dakota for the support of common schools. If sections 16 or 36 in a township had been sold prior to statehood, in lieu selections were granted. The grant of land totaled more than 2.5 million acres. Under sections 12, 14, 16 and 17 of the Enabling Act (and other acts referred to therein), Congress granted more land to the State for the support of colleges, universities, the state capitol and other public institutions. These additional grants totaled approximately 668,000 acres, bringing the grand total of Enabling Act land grants to nearly 3.2 million acres. Due to foreclosures, gifts, and other means, additional surface and mineral acres have been obtained.

To manage the assets, Article IX of the North Dakota Constitution created the Board of University and School Lands, more commonly referred to as the Land Board. The Department of Trust Lands (Department) serves as the administrative agency of the Land Board. The primary responsibility of the Department is to manage the permanent educational trust funds and assets under the Land Board's control as outlined in the North Dakota Constitution.

According to Department information, approximately 80% of the land granted has been sold. Prior to 1939, whenever grant land was sold, the state reserved no rights in the minerals. From 1939 to 1941, the state maintained 5% of the mineral rights on grant land sold. In 1941, the reservation was increased to 50%. Since June 28, 1960, the state has retained a 100% mineral reservation.

The Department manages approximately 656,000 surface acres of original grant land and 51,000 surface acres of lands acquired through foreclosures and other means. The Department manages mineral rights to more than 2.6 million acres. The mineral acres include approximately 760,000 of sovereign mineral acres. In 1977, the legislature transferred management authority for mineral acres acquired by the Bank of North Dakota and State Treasurer and responsibility for the mineral acres under sovereign land (navigable rivers/lakes) to the Land Board.

### Surface Management Division

The division is responsible for the management of the surface acres. The objective of surface management is to obtain a "fair market" return from the lands while maintaining or improving their condition and value. The Department holds public auctions of surface acres and enters into leases (such as for grazing) for the use of the land. The leases generate income for the trust assigned to the land. Revenue is also generated for trusts through right-of-ways, salt water disposal wells, and gravel mining. The table on the following page includes approximate surface acres assigned to the respective trusts (information we identified from the Department's database as of September 2015).

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**Appendix B**  
**Tract and Trust Information**

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<b>Surface Acres per Trust</b> (acres rounded)	
<b>Trust</b>	<b>Acres</b>
Capitol Building	9,990
Common Schools	632,040
Ellendale State College	4,910
Indian Cultural Education	160
Mayville State University	3,200
North Dakota State College of Science	3,710
North Dakota State University	15,120
Other	3,710
School for the Blind	3,480
School for the Deaf	4,830
School of Mines	3,310
State Hospital	2,210
University of North Dakota	8,900
Valley City State University	4,900
Veterans' Home	2,750
Youth Correctional Center	3,580
<b>Total</b>	<b>706,800</b>

Minerals Management Division

The division is responsible for the management of the mineral acres. The Department holds public auctions of mineral acres and enters into leases for the extraction and production of minerals. The leases generate income for the trust assigned to the mineral tracts. Revenue is generated for trusts through the production of oil, gas, coal, and other minerals. According to Department information, the division manages an interest in approximately 5,000 producing wells (as of June 30, 2015). The table on the following page includes approximate mineral acres assigned to the respective trusts (information provided by the Department in October 2015). Acre amounts are the net amount taking into consideration the gross acres and the percentage of the state's interest in the acres. For example, for a 160 acre tract the state owns 50% of the mineral rights, the net mineral acres in the table would be 80.

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**Appendix B**  
**Tract and Trust Information**

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<b>Mineral Acres per Trust</b> (acres rounded)	
<b>Trust</b>	<b>Acres</b>
Capitol Building	27,690
Common Schools	1,525,180
Ellendale State College	10,520
Indian Cultural Education	80
Mayville State University	16,130
North Dakota State College of Science	18,480
North Dakota State University	65,580
Other	3,450
School for the Blind	15,310
School for the Deaf	20,620
School of Mines	20,710
State Hospital	9,950
Strategic Investment and Improvements Fund (SIIF)	758,880
University of North Dakota	42,100
Valley City State University	19,800
Veterans' Home	13,240
Youth Correctional Center	32,950
<b>Total</b>	<b>2,600,670</b>

Trusts

The Department manages the following 13 permanent educational trust funds established to provide ongoing funding for education:

- Common Schools (K-12 public education)
- Ellendale State College
- Mayville State University
- North Dakota State College of Science
- North Dakota State University
- School for the Blind
- School for the Deaf
- School of Mines
- State Hospital
- University of North Dakota
- Valley City State University
- Veterans' Home
- Youth Correctional Center

Revenues are generated through the management of permanent trust assets, consisting of surface acres, mineral acres, and financial assets. All revenues generated are to be credited to the respective trust funds and are invested in a diversified portfolio of financial assets. According to Section 2 of Article IX of the North Dakota State Constitution, biennial distributions from the permanent trust funds must be 10% of the five-year average value of trust assets, excluding the value of lands and minerals. The average value of trust assets

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**Appendix B**  
**Tract and Trust Information**

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is determined by using the assets' ending value for the fiscal year ending one year before the beginning of the biennium and the assets' ending value for the four preceding fiscal years. Equal amounts must be distributed during each year of the biennium.

The Common Schools Trust Fund is the largest of the permanent trusts. This trust is for the support and benefit of K-12 public education. Except for Ellendale State College, the remaining trust funds are for the support and benefit of the college or university the trust is named for. Ellendale State College had a fire in 1970 effectively closing the school. In 1973, state laws related to Ellendale State College were repealed. The beneficiaries of the Ellendale State College Trust Fund became Dakota College at Bottineau, Dickinson State University, Minot State University, North Dakota State College of Science, School for the Blind, State Hospital, and the Veterans' Home. The benefits of the original grant of the School of Mines trust are distributed to the University of North Dakota.

The following two tables include information from the Department's audited financial statement related to the net asset balances and distributions made from each of the permanent trusts.

<b>Net Asset Balance as of June 30<sup>th</sup></b> (amounts rounded)			
<b>Trust</b>	<b>2011</b>	<b>2013</b>	<b>2015</b>
Common Schools	\$1,622,413,000	\$2,417,364,000	\$3,437,998,000
Ellendale State College	4,593,000	6,528,000	8,626,000
Mayville State University	2,855,000	4,756,000	6,412,000
North Dakota State College of Science	8,594,000	11,166,000	14,463,000
North Dakota State University	26,212,000	40,850,000	55,758,000
School for the Blind	3,130,000	5,643,000	7,618,000
School for the Deaf	9,353,000	14,036,000	18,478,000
School of Mines	10,132,000	12,795,000	16,554,000
State Hospital	9,300,000	11,125,000	12,810,000
University of North Dakota	12,943,000	18,600,000	26,205,000
Valley City State University	4,454,000	6,678,000	9,801,000
Veterans' Home	3,035,000	4,036,000	4,748,000
Youth Correctional Center	10,387,000	16,342,000	23,047,000
<b>Total</b>	<b>\$1,727,401,000</b>	<b>\$2,569,919,000</b>	<b>\$3,642,518,000</b>

**Appendix B**  
**Tract and Trust Information**

<b>Distributions by Biennium</b>			
(amounts rounded)			
<b>Trust</b>	<b>2009-11</b>	<b>2011-13</b>	<b>2013-15</b>
Common Schools	\$77,178,000	\$92,514,000	\$130,326,000
Ellendale State College	196,000	220,000	346,000
Mayville State University	178,000	184,000	236,000
North Dakota State College of Science	388,000	492,000	682,000
North Dakota State University	1,238,000	1,424,000	2,066,000
School for the Blind	206,000	216,000	282,000
School for the Deaf	360,000	454,000	720,000
School of Mines	428,000	560,000	794,000
State Hospital	456,000	572,000	754,000
University of North Dakota	692,000	750,000	1,020,000
Valley City State University	260,000	286,000	372,000
Veterans' Home	248,000	248,000	276,000
Youth Correctional Center	438,000	528,000	810,000
Total	\$82,266,000	\$98,448,000	\$138,684,000

The Department also manages the following trust funds for either the State or other beneficiaries pursuant to state law:

- **Capitol Building Fund:** Section 12 of the Enabling Act of 1889 authorized a land grant “for the purpose of erecting public buildings at the capital.” State law defines the fund, outlines its purposes, and assigns management of the land and the fund’s investment to the Land Board. Unlike the permanent trust funds, the Capitol Building Fund is fully expendable and is subject to a legislative appropriation each biennium.
- **Coal Development Trust Fund:** Established in state law, the primary purpose of the Coal Development Trust Fund is to provide loans to coal impacted counties, cities, and school districts as provided by NDCC Section 57-62-03 and for loans to school districts pursuant to NDCC Chapter 15.1-36. The Land Board is responsible for administering the trust. The Fund receives 30% of the coal severance tax. Any balance not loaned is invested according to the policies of the Land Board. The income earned is transferred to the State General Fund each year.
- **Indian Cultural Education Trust:** Created in 2003, the trust is managed by the Land Board for the benefit of the Mandan, Hidatsa, and Arikara Nation Cultural Education Foundation. The trust’s assets are managed and distributions are determined in the same manner as the permanent trust funds.
- **Strategic Investment and Improvements Fund (SIIF):** Revenues earned from the sovereign mineral acres are credited to SIIF. The minerals are located under navigable rivers and lakes and also include those formerly owned by the Bank of North Dakota and State Treasurer. In addition, SIIF receives a portion of the oil and gas production and extraction taxes collected by the State. SIIF moneys may be appropriated by the legislature for one-time expenditures relating to improving state infrastructure or for initiatives to improve the efficiency and effectiveness of state government.

The two tables on the following page include information from the Department’s audited financial statement related to the net asset balances and distributions made from other trusts.

**Appendix B**  
**Tract and Trust Information**

<b>Net Asset Balance as of June 30<sup>th</sup></b> (amounts rounded)			
<b>Fund</b>	<b>2011</b>	<b>2013</b>	<b>2015</b>
Capitol Building Fund	\$3,368,000	\$2,841,000	\$5,904,000
Coal Development Trust Fund	63,450,000	65,300,000	67,371,000
Indian Cultural Education Trust	668,000	759,000	1,174,000
Strategic Investment and Improvements Fund	249,074,000	969,920,000	793,727,000
<b>Total</b>	<b>\$316,560,000</b>	<b>\$1,038,820,000</b>	<b>868,176,000</b>

<b>Transfers by Biennium</b> (amounts rounded)			
<b>Fund</b>	<b>2009-11</b>	<b>2011-13</b>	<b>2013-15</b>
Capitol Building Fund	\$107,000	\$1,809,000	\$1,092,000
Coal Development Trust Fund	7,030,000	6,365,000	6,181,000
Indian Cultural Education Trust	0	0	0
Strategic Investment and Improvements Fund	35,814,000	312,357,000	1,428,930,000
<b>Total</b>	<b>\$42,951,000</b>	<b>\$320,531,000</b>	<b>\$1,436,203,000</b>

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## Chapter 1 Supplemental Responses & Concluding Remarks

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### Recommendation 1-5

We recommend the Department of Trust Lands establish:

- a) An interest rate to be assessed on late oil and gas royalty payments.
- b) A policy identifying the circumstances under which interest will be assessed.

### Management's Responses

The Department disagrees with these recommendations.

The Department considers the collection of royalties on behalf of the trusts and the State as its primary objective in the management of oil and gas assets and it believes that the application of interest should be when lack of royalty payment is obstinate. The majority of royalties received past 150 days were a result of title issues or adjustments.

The audit finding cites NDCC § 47-16-39.1 as requiring the Commissioner to establish or negotiate an interest rate used by the operator related to late payments. The law is actually permissive in reference to the adjustment of interest for unpaid royalties upon Board managed minerals. The statute reads in part: *"without the requirement that the mineral owner or the mineral owner's assignee request the payment of interest, at the rate of eighteen percent per annum until paid, except that the commissioner of university and school lands may negotiate a rate to be no less than the prime rate as established by the Bank of North Dakota plus four percent per annum with a maximum of eighteen percent per annum, for unpaid royalties on minerals owned or managed by the board of university and school lands."* (emphasis added).

Similarly, the Board's rules, which govern its leasing of oil and gas minerals in chapter 85-06-06, state that the Commissioner may collect penalties, interest, or both upon the late payment of royalties. This rule provides discretion so that complexities due to timing, title and legal issues can be considered in application of interest. This adaptability is intentional and has proven useful in the negotiation and collection of royalties.

More rigid policies could prompt litigation, thus the Department will consult with legal counsel before recommending revisions to the Board's rules.

### State Auditor's Concluding Remarks

The Department's response is misleading. We do not state NDCC requires the Commissioner to establish or negotiate a rate. We accurately include the provisions of state law. When an operator paid the Department less than 18% interest, we identified no negotiation between the Commissioner and operator. Also, NDCC requires operators to pay interest, if applicable. State law only provides authority to the Commissioner to negotiate a lower interest rate, not waive interest. The Department states more rigid policies could prompt litigation. However, we are concerned the current practices could prompt litigation.

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**Appendix C**  
**Chapter 1 Supplemental Responses & Concluding Remarks**

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**Recommendation 1-8**

We recommend the Department of Trust Lands ensure the minimum opening bids for pastureland result in a “fair market” return.

**Management’s Response**

The Department agrees with this recommendation.

The Fair Market Value Method of calculating the minimum opening bids at public auction was adopted by the Board in 1989 and subsequently often revised. The FMV Method calculates the opening bids on a tract-by-tract basis based upon a local rent survey and land productivity data. Because the productivity data is based on vegetation zones and the rent data is county based surveys, the FMV Method blends two data sets into a coherent methodology.

The Department now has extensive cash rent survey data available and since the vegetation zones have been refined by the USDA NRCS into Major Land Resource Areas, this information could be used along with more precise ecological and economic information, to review and possibly update the FMV Method.

This FMV review will be balanced with the risk of raising minimum opening bids to a level that tracts will not be leased resulting in decreased revenue and increased management costs.

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**Recommendation 1-10**

We recommend the Department of Trust Lands ensure:

- a) Agreements are entered into and/or information is obtained for inspections not conducted by the Department on state owned tracts.
- b) Appropriate action is taken when violations or other concerns are identified on surface tracts.

**Management’s Response**

The Department agrees with these recommendations.

The Department has a cooperative management relationship with grazing associations and the US Forest Service. Trust land within grazing units in the National Grasslands is annually inspected by the grazing associations and livestock use is adjusted based upon weather and guidelines established by the Forest Service. There is not a written agreement between the grazing associations and the Department, so one will be developed to document the relationship and reporting requirements.

Land improvement programs, including a major cooperative trash clean-up effort, were instituted in 1992. Regular five-year inspections are conducted by experienced Department field staff to identify trash, safety, or management issues that need to be addressed. When requested to resolve a problem, the vast majority of lessees make the adjustments or implement changes without enticement or penalty. The trusts are fortunate to partner with good agriculture managers who share similar values in protecting and improving trust lands.

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**Appendix C**  
**Chapter 1 Supplemental Responses & Concluding Remarks**

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The Department will review inspection agreements and will implement appropriate action in response to repeated or uncorrected abuses of trust surface lands.

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## Chapter 2 Supplemental Responses & Concluding Remarks

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### Recommendation 2-1

We recommend the Department of Trust Lands:

- a) Ensure fiduciary responsibilities are fulfilled.
- b) Ensure public funds are used in an appropriate manner.
- c) Enhance the organizational culture of accountability.

### Management's Responses

The Department agrees with the recommendations as provided. The Department staff are keenly aware of their responsibilities as fiduciaries for beneficiaries of the permanent trusts, the state and unclaimed property owners, but recognize that there is always room to improve. The Department takes its role and responsibility of managing natural resources and assets to provide educational and institutional funding, supporting energy impacted communities and serving unclaimed property owners seriously.

Responses to the examples of issues:

#### Trusts Assigned to tracts:

This example was previously identified and a Management Response provided in recommendation 1-1 of Chapter 1. The Department agrees that there were errors and that it will take steps to correct them.

#### Royalty Payments:

A response to these details was provided in an earlier chapter of the audit, specifically in recommendations 1-2 and 1-3. The Department agrees that mistakes occurred and it will work to improve processes.

#### Interaction with vendors:

On behalf of the trusts, the Department staff undertake careful reviews and make recommendations regarding sizeable investment decisions. Part of the review involves understanding an investment firm's style, culture, and fiduciary approach towards managing money for others.

As described in its response to auditors' recommendation 2-6, the Department believes that all interactions have followed its Code of Ethics policy. The Department will review meeting documentation, and if meals or other items of value were improperly accepted by employees, reimbursement will be required.

#### Reimbursement for meals:

The Department will review the identified instances when employee meals were provided by a contractor or vendor; if per diem was also provided, repayment from the employee will be required.

#### Use of funds

The Department will review the selected transactions and address the specific concerns as needed.

- The Department will require reimbursement from the two employees who apparently received a per diem meal reimbursement when a meal was included in conference registration. If the employees are no

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## Appendix D

### Chapter 2 Supplemental Responses & Concluding Remarks

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longer employed with the State, the Commissioner will reimburse the Department.

- Due diligence is an industry standard and an essential component of the investment process; it involves confirming that information provided by an investment firm accurately portrays the firm and the product in which an entity is considering investing. Whenever possible, the Department works to minimize the cost of due diligence trips, or any travel.
- Department policy encourages part-time employees to use personal a UTV or ATV to conduct field inspections; because it saves the Department the cost of providing and maintaining these machines that improve employee productivity. In the instance noted, this policy resulted in nominal added expense. The policy is being reviewed to ensure allowable reimbursement is more closely aligned with usage.
- Regarding procurement, a response to this example is provided to recommendation 2-2 in the succeeding section. The Department will enhance compliance with procurement laws and policies.
- The Common Schools Trust Fund owns the office building occupied by the Department. As the landlord it provides the space, utilities, and all other fixtures related to office occupancy; including the parking lot, bathrooms, conference rooms, and a breakroom. Since there is no cafeteria or dining option within near proximity, a provided coffee maker and kitchen appliances allow employees the option of onsite meals. The Department does not purchase food or coffee for employees or guests.
- The Department has provided responses to salary management recommendations in Chapter 3 within recommendations 3-5 and 3-6. The Department believes that its salary increases were in compliance with session law and administrative rules.

During the period reviewed by the audit, the Department and the trusts it manages experienced unprecedented growth in both dollars and responsibilities. The Department acknowledges that mistakes have been made that do not reflect the high standards that the staff embraces.

However, the Department rejects the assertion made herein, through the assemblage of unrelated issues, that fiduciary responsibilities are not being fulfilled, public funds are being used inappropriately, and that the organization lacks accountability.

The Department is proud of the work it does on behalf of all of its beneficiaries. Even during challenging periods, it has never lost sight of its responsibility to sensibly oversee the permanent trusts, and the other funds and programs that have been entrusted to it. The Department

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**Appendix D**  
**Chapter 2 Supplemental Responses & Concluding Remarks**

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welcomes the opportunity to continuously improve its management of these assets and programs.

**State Auditor's Concluding Remarks**

The Department's response is misleading. While the Department states it agrees with the recommendation, the response relates to disagreement with our conclusion of the Department not fulfilling their fiduciary responsibilities, using certain funds inappropriately, and lacking accountability within the organization.

Interaction with Vendors

The Department's response is not related to the area addressed in the report. The Department attempts to justify conducting reviews of vendors. However, the inappropriate interactions with vendors (free meals and drinks, having spouses attend dinners) is not addressed by the Department.

Use of Funds

The Department's response states due diligence involves confirming information provided by an investment firm accurately portrays the firm and the product in which an entity is considering investing. The Department maintains limited, to no, documentation of the due diligence visits to support what, if any, review is conducted. Current technology would provide a less expensive means to obtain similar information.

The Department's response to salary management information is contradictory. While the Department states it believes salary increases were in compliance with session law and administrative rules, the Department agreed to Recommendations 3-5 and 3-6. We conclude in Chapter 3 the Department was in noncompliance with certain salary increase requirements included in session laws and administrative rules.