Legislative Audit Division

State of Montana

Report to the Legislature

November 2002

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 2002

Department of Natural Resources and Conservation

This report contains eight recommendations. Issues addressed in the report relate to:

- **Improving the recording and accounting of financial activity on the state accounting system and implementing an oversight control procedure.**
- **Compliance with state laws and regulations.**

This report also contains a disclosure issue regarding Article X of the State Constitution and state laws governing trust land administration and public school funding.

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Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2003, will be issued by March 31, 2004. The Single Audit Report for the two fiscal years ended June 30, 2001, was issued on March 26, 2002. Copies of the Single Audit Report, when available, can be obtained by contacting:

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November 2002

The Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report on the Department of Natural Resources and Conservation for the two fiscal years ending June 30, 2002. The report contains a qualified opinion on the department's financial schedules. Included in this report are eight recommendations to the department concerning compliance with state laws and policies, and accounting issues. The department's written response to audit recommendations is included in the audit report.

We thank the director and his staff for their cooperation and assistance throughout the audit.

Respectfully submitted,

(Signature on File)

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Legislative Audit Division

Financial-Compliance Audit
For the Two Fiscal Years Ended June 30, 2002

Department of Natural Resources and Conservation

Members of the audit staff involved in this audit were Angela Lang, Jim Manning, Alexa O'Dell, and Jennifer Solem.

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Department of Natural Resources and Conservation

This report documents the results of our financial-compliance audit of the Department of Natural Resources and Conservation (department) for the two fiscal years ended June 30, 2002. The previous report contained seven recommendations to the department. The department implemented five recommendations and partially implemented two recommendations.

This report contains eight recommendations directed to the department. The first section in the report concerns accounting issues and discusses ways the department can improve compliance with state accounting policy and reduce errors on the department's accounting records. There are four recommendations related to accounting issues.

The second section discusses compliance with state laws and how the department could improve compliance with state laws. There are two recommendations related to compliance with state laws.

The last two report issues relate to federal compliance items. There are two recommendations regarding preparation of the Schedule of Expenditures of Federal Awards and the Timing of State Revolving Fund Audits.

This report also contains a disclosure issue relating to the distribution and use of Public School Fund mineral royalty receipts.

We issued a qualified opinion on the financial schedules contained in the report for each of the two years under audit. This means the reader should use caution when using the presented financial information and the supporting data on the state's accounting records.

The departments written response to the audit begins on page B-3.

The listing below serves as a means of summarizing the recommendations contained in the report, the department's response thereto, and a reference to the supporting comments.

Recommendation #1

We recommend the department:

A. Record nonbudgeted expenditures activity in the proper subclass.

Department Response: Concur. See page B-3.

B. Work with the Department of Administration to establish SABHRS controls to prevent transactions with invalid department subclasses from posting to the accounting system. 8

Department Response: Concur. See page B-3.

Recommendation #2

We recommend the department:

A. Record accounting transactions in accordance with state law and policy

Department Response: Concur. See page B-3.

B. Implement an oversight control procedure to detect and correct accounting errors.. 13

Department Response: Concur. See page B-3.

Recommendation #3

We recommend the department continue to work with the Department of Administration to develop accounting procedures for recording easements. 14

Department Response: Concur. See page B-3.

Introduction

We performed a financial-compliance audit of the Montana Department of Natural Resources and Conservation (department) for fiscal years 2000-01 and 2001-02. The objectives of the audit were to:

1. Determine the department's compliance with applicable laws and regulations.
2. Make recommendations for improvement in the department's internal and management controls.
3. Determine if the department's financial schedules fairly present the results of its operations for the two fiscal years ended June 30, 2002.
4. Determine the implementation status of prior audit recommendations

This report contains eight recommendations to the department. Other concerns not having a significant effect on the successful operations of the department are not specifically included in this report but have been discussed with management.

In accordance with section 5-13-307, MCA, we analyzed and disclosed the cost, if significant, of implementing the recommendations made in this report. We evaluated charges for services for costs incurred in the Internal Service Fund as required by section 17-8-101(6), MCA, and found the charges and fund equity to be reasonable for the operations in the fund.

Background Information

The Executive Reorganization Act of 1971 established a department to manage the state's natural resources. In 1995, the reorganization of Montana's natural resources and environmental agencies resulted in the current Department of Natural Resources and Conservation. The mission statement of the Montana Department of Natural Resources and Conservation is:

> "To help ensure Montana's land and water resources provide benefits for present and future generations."

The department executes its mission by promoting the stewardship of Montana's water, soil, forest, and rangeland resources, and regulating forest practices and oil and gas exploration and production.

Department Organization

The department employs nearly 500 people in Helena and its 40 field offices throughout the state. The department is organized into the following divisions and commissions.

Central Services Division (41 FTE) provides administrative and operational support to all divisions. The division coordinates the fiscal bureau, information technology bureau, personnel bureau, and purchasing bureau to provide this support. Fiscal services include financial activities and trust revenue collection and distribution, as well as bond and loan accounting. The division also produces publications and graphic materials for educational and informational purposes.

Conservation and Resource Development Division (22 FTE) provides technical and financial assistance to local governments, state agencies, and private citizens for the conservation, development, protection, and management of the state's natural resources. The division consists of the Conservation Districts Bureau, Financial Development Bureau and the Resource Development Bureau. The Conservation Districts Bureau is responsible for assisting Montana's 58 conservation districts and 29 grazing districts. The Financial Development Bureau is responsible for preparing and managing the cash flow of the division's programs. The bureau also issues loans to borrowers and manages the financial administration of Montana's Water Pollution Control State Revolving Fund and Drinking Water State Revolving Fund loan programs. The loan portfolio through fiscal year 2002 exceeded $179 million. The Resource Development Bureau administers several grant and loan programs and provides assistance to conservation districts for the administration of water reservations. These programs include reclamation and development grants, renewable resource grants and loans, treasure state endowment loans, conservation district water reservations and irrigation development. The Renewable Resource Public Loan Program makes loans to communities for renewable resource projects (dam rehabilitation and irrigation system improvements), and has approximately $36 million in outstanding loans as of June 30, 2002. The State Wastewater Revolving Fund Loan program provides low interest loans to communities to fund wastewater treatment projects. The outstanding loans at June 30, 2002, totaled approximately $70 million.

Forestry Division (168.15 FTE) protects Montana's natural resources from wild fires through regulation and partnerships with federal, state, and local agencies, and helps Montanans achieve land stewardship and compliance with state forestry laws. This division's headquarters are located in Missoula. The division provides fire suppression services, staffing 65 engine companies and 5 helicopters to provide direct protection of 5.1 million acres. In addition, the division provides secondary fire protection responsibility for an additional 45.3 million acres of state and privately-owned non-forested land through the State/County Cooperative Fire Protection program. The division operates a nursery to provide stock for shelter belts, windbreaks, wildlife habitat improvement and reclamation, and reforestation of state and public lands. Nursery sales in fiscal year 2002 were approximately 1.1 million plants generating $368,797 in revenue. The division also regulates forest practices and wildfire hazards created by logging or other forest management operations on state and private lands.

Oil and Gas Conservation Division (20.5 FTE) prevents waste and provides for the conservation of crude oil and natural gas through regulation of exploration and production.

The Board of Oil and Gas Conservation has seven members and administers the Montana oil and gas conservation laws through its main office in Billings. The board issues drilling permits, classifies wells, and establishes well spacing units. The Board also inspects drilling, production and seismic operations and investigates complaints. Engineering studies are conducted to collect and maintain well data and production information. The Board operates the federal Underground Injection Control Program for injection or disposal wells to protect underground sources of drinking water.

Reserved Water Rights Compact Commission (12 FTE) is comprised of nine commissioners who negotiate water rights settlements with Indian Tribes in Montana and federal agencies claiming rights within the state to establish formal agreements on the amount of water to be allocated to each interest. Its staff provide support services such as historical and legal research and analysis of soils, vegetation, and hydrology.

Trust Land Management Division (124.1 FTE) is responsible for managing the state's trust land resources to produce revenues for the trust beneficiaries while considering environmental factors and protecting the future income-generating capacity of the land. Approximately $13.2 million in revenues were generated in 2002 from the management of the agricultural and grazing resources of state trust lands. The department also manages other state land resources such as timber sales ($8.2 million), mineral management ($9.4 million), and special uses ($2.3 million). The major beneficiary is Montana's public schools, as well as other endowed institutions.

Under the direction of the State Board of Land Commissioners, the director administers the state trust land management functions vested in the department. The Board oversees the administration of state trust land, making decisions as directed by the Montana Constitution. The Board is comprised of five elected officials including the Governor, Superintendent of Public Instruction, Secretary of State, Attorney General, and State Auditor.

Water Resource Division (112.5 FTE) strives to provide the most benefit, through the best use, of the state's water resources for the people of Montana. The division administers state-owned water resources projects, water rights, and water reservations. Its activities include interstate coordination of water issues, centralized water rights record keeping, state water planning, dam safety, floodplain management, and drought planning. The division also operates the Broadwater Power project to maximize revenues from the sale of electricity. The division provides administrative support to the Board of Water Well Contractors, which establishes minimum well construction standards and licenses well drillers.

Prior Audit Recommendations

Prior Audit Recommendations

We performed an audit of the department for the two fiscal years ended June 30, 2000. The report contained seven recommendations. The department concurred with all of the recommendations. Of the seven recommendations, the department implemented five and partially implemented two of the recommendations. The recommendations partially implemented relate to deposits from trust land management offices (page 16) and revenue recognition (page 14).

Findings and Recommendations

Accounting Issues

The following report sections discuss instances where the department could improve compliance with state accounting policy and thereby improve the overall reliability and usefulness of the financial information contained in the Statewide Accounting, Budgeting, and Human Resource System (SABHRS). Section 7-6-609, MCA, states: "It is the policy of the state of Montana that all governmental accounting systems be established and maintained in accordance with generally accepted accounting principles that are nationally recognized as set forth by the governmental accounting standards board or its generally recognized successor." By law, the Department of Administration is responsible for establishing state accounting policy and prescribing and maintaining a uniform accounting system (SABHRS) in accordance with generally accepted accounting principles (GAAP).

During the audit period, major revisions were made to state accounting policy to comply with changes in generally accepted accounting principles. The Governmental Accounting Standards Board issued Statement 34 (GASB 34) that for the state of Montana is effective for all accounting periods ending after June 30, 2001. GASB 34 is one of the most significant changes in GAAP to affect governmental accounting in years. Many of the issues noted in the following sections resulted from the significant changes due to GASB 34, the department's unfamiliarity with the new requirements or changes in state policy, the timing of the changes, and the additional work required to implement the changes.

Subclass (Program) Coding Errors

The department uses the Statewide Accounting, Budgeting, and Human Resource System, SABHRS, to record financial activity as required by state law. In September 2001, SABHRS required a subclass (program) to be identified for each nonbudgeted transaction. Prior to this date, nonbudgeted activity could be processed without a subclass (program) ID. The subclass coding in SABHRS determines which program expenditures are grouped or classified in. The expenditure programs are reflected in the columns on the Schedules of Total Expenditures and Transfers-Out appearing on pages A-9 and A-10.

Nonbudgeted transactions recorded on SABHRS are not subjected to the same edit checks as budgeted transactions. SABHRS only verifies the subclass (program) field is entered, not that the subclass identified is a valid program for the business unit to which the transaction is posting. Due to the incorrect subclass coding and the lack of edit checks for nonbudgeted transactions, the Schedules of Total Expenditures and Transfers-Out for each fiscal year of our audit period do not accurately present department activities by program. As discussed below, program coding errors posted during the audit period that we identified totaled $542,791.

> The Schedule of Total Expenditures and Transfers-Out for fiscal year 2001 (page A-10) presents a separate program column titled the State Compensation Mutual Insurance Fund. The $196,850 transfer should have been included in the Conservation and Resource Development Division program.
>
> In fiscal year 2002, the Schedule of Total Expenditures and Transfers-Out (page A-9) erroneously presents two programs titled R05 and R06 because of coding errors. The $263,897 transfer shown in the R05 column should have been included in the Trust Funds program while the R06 column should have been included in the Conservation and Resource Development Division program.
>
> In addition, on the fiscal year 2002 schedule, the Admin Financial Services Division column is shown due to coding errors. Admin Financial Services Division is a program of the Department of Administration. In fiscal year 2002, the Department of Administration executed a journal for payment of General Obligation Bonds and coded the DNRC portion of the journal entry to a Department of Administration subclass. Although DNRC was required to approve the transaction before it could post to SABHRS, the mistake was not identified by DNRC, and the transaction was approved for posting. The $82,050 debt service payment should have been included in the Conservation and Resource Development Division program.

The department uses SABHRS organization reports to track expenditure activity each month and ensure the transactions processed on SABHRS. However, these reports do not identify program (subclass) coding. The department does not have a control to detect subclass errors. Therefore, the department did not identify the errors in subclass coding.

Recommendation #1
We recommend the department:

A. Record nonbudgeted expenditures activity in the proper subclass.

B. Work with the Department of Administration to establish SABHRS controls to prevent transactions with invalid department subclasses from posting to the accounting system.

GASB 34

The Governmental Accounting Standards Board issued Statement 34 (GASB 34) that is effective in Montana state government for all accounting periods ending after June 30, 2001. Major accounting changes required by GASB 34 involved accounting for long-term assets and liabilities. The intent of GASB 34 was to provide for a more complete and fair disclosure of long-term assets and liabilities. Long-term assets include fixed assets (land, buildings, dams), while long-term liabilities include long-term debt items such as bonds and long-term notes payable. Prior to GASB 34, long-term assets or liabilities were isolated from the financial activity reported in the governmental funds general ledgers. The fixed assets and long-term debt were recorded in separate "account groups," outside of the fund ledgers. With the implementation of GASB 34, the account groups are eliminated and fixed assets and long-term liabilities must be recorded in the individual fund ledgers.

In order to facilitate these accounting changes, the Department of Administration issued new state accounting policies as well as detailed instructions to implement the changes. Although the new policies were effective as of July 1, 2001, the written policies and procedures were not provided to agencies until mid-July 2002 during the fiscal year end period.

The following paragraphs discuss instances where the department did not properly record accounting transactions in accordance with the changes in accounting policy necessary to implement GASB 34. As noted below, these errors result in misstatements on the department's accounting records.

Bond Recording Errors

In fiscal year 2001-02 the department issued Coal Severance Tax revenue bonds, series 2001C and 2001D, and used part of the proceeds to pay off previously issued bonds. These transactions are known as refunding bonds. At the time the activity took place, the department properly recorded the transaction on the state's accounting records. However, the Department of Administration issued new accounting policy regarding bonds in mid-July 2002 to implement GASB 34 requirements. The policy had a retroactive effective date of July 2001. For refunding bonds, the new accounting policy requires two transactions: one to retire the debt associated with the old bonds, and one to record payment to the bond escrow agent. By fiscal year-end closing 2002, the department did not make all entries necessary to comply with the new accounting policy. The following paragraph describes errors in the bond transactions that have an effect on the schedules presented in this report.

In its entries to pay for the retirement of the old bond issues, the department recorded some activity as Debt Service-Bonds expenditures and some activity as Accounting Entity Transfers-Out. According to the new state accounting policy, these expenditures should be recorded as Benefits and Claims-Other Financing Uses. As a result, Debt Service-Bonds and Accounting Entity Transfers-Out are overstated by $12,278,873 and $22,476,186, respectively, while Benefits and Claims-Other Financing Uses is understated by $34,755,059 in the Schedule of Total Expenditures and Transfers-Out for fiscal year 2002 (page A-9). These errors contributed to the qualified opinion issued for the Schedule of Total Expenditures and Transfers-Out for fiscal year 2002.

Fixed Assets

As part of implementing changes required by GASB 34, the department was required to transfer fixed asset cost and related accumulated depreciation activity from the fixed asset account group to the individual funds. Although the conversion was executed through an automated SABHRS process which transferred data according to classification in the account group, the department was responsible for ensuring the classifications were accurate prior to the conversion.

New state accounting policy regarding fixed assets issued in May 2002 indicated two new asset classifications, Infrastructure and Land Improvements, were required by GASB 34. The policy stated most assets formerly recorded as Other Improvements should be reclassified as Infrastructure. The Other Improvements account and the related Accumulated Depreciation account were renamed Building Improvements during fiscal year 2001-02.

In February 2002, the Department of Administration provided agencies a list of Other Improvements assets recorded at fiscal year-end 2001 that likely required reclassification. The list included $115,213,125 of Other Improvements assets for the department. By fiscal year-end, transactions to reclassify Other Improvements assets to Infrastructure had not been made. Department personnel noted they did not make the entries as they misinterpreted the accounting policy.

As a result, Building Improvements and Accumulated Depreciation-Building Improvements are overstated by $114,803,866 and $71,284,806, respectively, at fiscal year-end 2002. Infrastructure and Accumulated Depreciation-Infrastructure are understated by the same amounts. Since all misclassification are in asset accounts, there is no effect on the financial schedules included in this report.

Notes Payable

The department eliminated long-term notes payable for the Tongue River Dam and Middle Creek Dam projects from the long-term account group as required by GASB 34; however, the amounts were not reestablished on SABHRS. There were four other funds affected by account group eliminations, but the amounts were appropriately recorded on SABHRS. Department personnel indicated they were aware the Tongue River Dam and Middle Creek Dam payables needed to be recorded, but it was overlooked at fiscal year end. Long-term notes payable and current notes payable are understated on the state's accounting records by $12,871,728 and $326,295, respectively, at fiscal year-end 2002. As of September 2002, entries had not been made to record the Tongue River Dam and Middle Creek Dam notes payable.

Transfers Coded to Incorrect Subclass

During the audit, we noted some transfers related to the State Revolving Fund programs were recorded to the Water Resources program instead of the Conservation and Resource Development Division (CARDD) program. The coding errors resulted in an overstatement of transfers-out in the Water Resources program and an understatement of transfers-out in the CARDD program of $3,683,000 in fiscal year 2000-01. The department noted new staff had coded these transactions to the wrong subclass. This resulted in a qualification on the Schedule of Total Expenditures & Transfers-Out for the fiscal year ended June 30, 2001 (page A-10).

Accounting Oversight Needed

The errors described in the previous four sections indicate the department can improve its controls over recording financial activity in accordance with state law and policy. We detected the errors by reviewing trial balances and financial schedules compiled from the department's accounting records for amounts that appeared unusual or unreasonable. The department could implement a similar monitoring review of the accounting records to detect and correct errors. In addition, department management should ensure that transaction review and approval and other control procedures are performed in time for corrections to be made prior to the end of the fiscal year.

Recommendation #2
We recommend the department:

A. Record accounting transactions in accordance with state law and policy

B. Implement an oversight control procedure to detect and correct accounting errors.

Easements

An easement is a legal interest in land that entitles the easement holder to a specific limited use of the land. Prior to the Executive Reorganization Act of 1995, which merged Montana's Department of State Lands with the Department of Natural Resources and Conservation, each department treated easements differently on the state's accounting records. State Lands recorded trust lands easements as Land Rent (operating expenses) while the prior Department of Natural Resources and Conservation recorded water rights easements as Land Easements (capital outlay expense).

Funds for each division continue to be budgeted to these objects. Therefore, Trust Lands Management Division and Water Resources Division easements are not recorded in the same manner. In fiscal year 2001-02, the department recorded $340,060 as Land Rent and $265,337 as Land Easements while in fiscal year 2000-01 the amounts were $229,850 and $0, respectively.

State policy requires that when the acquisition cost of an asset exceeds a specified amount, the asset should be recorded in the accounting records (capitalized) as a long-term, fixed asset. The department did not capitalize any easement purchases in either fiscal year. The department noted they sometimes take up to three years to pay for the purchase of an easement which makes it difficult to determine when the capitalization limit has been met. Under state policy, the capitalization limit for land and intangible assets is $5,000 for each individual item acquired.

Department of Administration's accounting bureau staff indicated the easements should be capitalized; however, it might require a new control account. Department officials stated they have met with the Department of Administration to discuss procedures to record easements. They explained there are no clear guidelines. Although current state accounting policy does not specifically address easements, the accounting policy defines Intangible Assets as a long-lived legal right. An easement is defined as an interest in land owned by another that entitles the easement holder to a specific limited use of the land. Most of the easements owned by the department are permanent in nature. Therefore, the department should capitalize all easements that meet the state capitalization criteria as intangible assets.

Recommendation #3
We recommend the department continue to work with the Department of Administration to develop accounting procedures for recording easements.

Revenue Recognition

Our prior audit report noted the department did not record the proper amount of revenue in the federal special revenue accounts at the end of the fiscal year as required by state accounting policy. The funds affected by these misstatements were the Tongue River Dam project and the Tongue River Tribal Loan. In fiscal year 2000-01, the department made the appropriate entries to record revenue. However, at June 30, 2002, the federal fund for the Tongue River Dam project reported $258,780 in deferred revenue. In order to properly match federal revenues with federal expenditures, the department should have recognized $84,915 of revenue and reduced deferred revenue by the same amount.

Department personnel indicated the revenue recognition was overlooked at fiscal year end. Timely review of the general ledgers could have detected or prevented this error. The department should review the general ledgers at fiscal year-end, specifically the federal funds, to determine the proper amounts of revenue to report in the accounting records.

Recommendation #4
We recommend the department properly record revenue in the accounting records by fiscal year-end to properly match revenue and expenditures in its federal funds.

Compliance With State Law

During the audit we identified the following instances where the department could improve compliance with state statutes.

Board of Adjustment

Conservation districts were formed in the 1930's in a response to severe soil erosion problems. Today Montana has 58 conservation districts that are charged with assisting citizens in natural resource conservation efforts. When a conservation district passes an ordinance, the district is required to provide for a Board of Adjustment whose duties include resolving discrepancies in ordinances.

Section 76-15-721, MCA, requires the department to appoint members of each Board of Adjustment and to remove members through a hearings process. According to the department, there are no Boards of Adjustment presently established in the state. Department personnel indicated the Board of Adjustment only has duties when a conservation district has an ordinance in effect that is more stringent than a state or other applicable law. According to department personnel only 2 of the 58 conservation districts have adopted any ordinances. Department personnel stated currently there are no ordinances in effect that are not applied to every conservation district since the ordinances have been incorporated into federal or state law. Therefore, they believe there is no need for any Board of Adjustment at the present time.

Recommendation #5
We recommend the department:

A. Establish a Board of Adjustment for each conservation district that has adopted an ordinance.

B. If necessary, seek legislation to eliminate or modify the board of adjustment requirement.

Timely Deposits

The department collects cash and checks for various fees and permits. Section 17-6-105, MCA, requires state agencies to make deposits when the total coin and currency collected exceeds $100 or total collections exceed $500. Deposits must be made at least weekly. State policy requires that payments collected at the field offices be deposited in a local bank account which has been established as an approved depository by the Department of Administration, Treasury Bureau. This policy was designed to enhance internal controls over collections, facilitate timely deposits, reduce risk of loss, and maximize investment earnings.

In the past two audit reports, there have been recommendations concerning timely deposits by the department. In August of 2001, the Centralized Services Division sent a new policy to the area and unit Water Resource and Oil and Gas offices. The policy detailed procedures for frequency and handling of deposits. It also referenced the deposit law noted above.

Water Resources and Oil and Gas

We traveled to three regional Water Resource offices, one Oil and Gas field office, and the Oil and Gas Conservation Division headquarters. The offices collect various license and permit fees. Based on a review of deposits at the offices visited, we noted four offices did not make timely deposits as required by state law. Department personnel at the different offices cited various reasons for not complying with the law.

Trust Land Management

The Trust Land Management Division maintains various field offices throughout the state. The division is responsible for collecting the various revenues produced from state trust lands. These revenue sources include mineral, forestry, grazing, and agricultural leases and royalties. As a matter of convenience for the lessees, the field offices collect some, but not all payments from lessees. Department officials noted that payments received by the area and unit offices, whether in checks and/or cash, are mailed to the Centralized Services Division in Helena, for deposit and processing. Mailing of payments to Helena for processing is not in compliance with state policy. In the previous two audits, we noted this same concern with the collections from the trust land field offices.

Department personnel noted the trust land management database is not set up to facilitate making deposits locally. The department requested and received funding from the 1999 Legislature for a new trust land management system. The new system will provide the capability to account for funds locally by the field offices. The contract was awarded during the fiscal year 2000-01. The latest estimate shows some offices will be able to use the system by April 2003.

Recommendation #6
We recommend the department ensure payments received at field offices are deposited in accordance with state law and policy.

Schedule of Expenditures of Federal Awards

At the end of each fiscal year, all agencies are required to complete a Schedule of Expenditures of Federal Awards (SEFA). The SEFA amounts are included in the state's biennial federal Single Audit report. According to the SEFA instructions provided by the Governor's Office of Budget and Program Planning, each federal financial assistance program must be placed on a separate row of the worksheet and the total expenditures of federal awards, including prior year adjustments and indirect costs, should be listed for each federal program.

During the audit, we noted there were two federal grants omitted, one grant reported an incorrect expenditure amount, and one grant with the wrong federal grant number on the department's fiscal year 2001-02 SEFA. In total the SEFA was understated by $544,758.

Recommendation #7
We recommend the department accurately and completely prepare its Schedule of Expenditures of Federal Awards.

Timing of State Revolving Fund Audits

The state's Water Pollution Control and Drinking Water State Revolving Fund programs are administered jointly by the Department of Environmental Quality and the Department of Natural Resources and Conservation (department). Historically, the department has requested a financial audit of these programs each year because annual audits are required by the federal Environmental Protection Agency. Federal regulations require the audit report to be completed within one year of the end of the appropriate fiscal year. As of September 2002, the audit of the State Revolving Fund programs for fiscal year 2001 has not been completed because final financial statements have not been provided by the department.

Recommendation #8
We recommend the department establish procedures to complete the State Revolving Fund financial statements to ensure the audit report can be completed within one year as required by federal regulations.

Mineral Royalties

This report section discloses issues relating to the distribution and use of Public School Fund mineral royalty receipts.

Article X of the Montana Constitution establishes the Public School Fund and provides that the Public School Fund shall forever remain inviolate, guaranteed by the state against loss or diversion. Article X Section 2 (1) defines the Public School Fund to include proceeds from school lands which occur when the state disposes of trust land or an interest therein, pursuant to Section 11. Article X distinguishes Public School Fund revenue and income in Section 5 and provides for the distribution of that revenue.

Moneys Placed in Trust Land Administration Account

Section 77-1-109 (a), MCA, allows the Department of Natural Resources and Conservation (department) to deposit mineral royalties, certain timber and easement revenue and interest and a portion of the trust income money received by the Public School Fund in the department's Trust Land Administration Account to pay for its management of trust lands. Most or all of the money deposited in this account would otherwise be deposited in the trust.

During fiscal years 1999-2000, 2000-2001, and 2001-2002, all of the money deposited in the administration account was mineral royalty revenues. Deposits in the administration account totaled more that $9.9 million for those three years. Mineral royalties have been determined by Montana courts to be the sale of an interest in real property, and as such are trust fund corpus assets. According to the courts, proceeds from the sale of trust fund assets should be deposited in the trust.

The use of these mineral royalty proceeds to pay for ongoing department operations may violate Article X section 3 of the Montana constitution. In a letter opinion dated April 30, 2001 the state's Code Commissioner questioned Section 77-1-109, MCA, in light of Article X section 5 which allocates 95 percent of income to schools and 5 percent to the Public School Fund.

Senate Bill 495 Authorized Purchase of Mineral Rights

Senate Bill 495 enacted by the 2001 legislature, authorized the Department of Natural Resources and Conservation to purchase mineral production rights held by the Public School Fund established in Article X, section 2 of the Montana Constitution for fair market value. The department purchased the mineral royalty proceeds stream for a period of 30 years, which we believe may not be the same as the mineral production rights. The Public School Fund still holds the title to the mineral production rights attached to school trust land. Because the authorized purchase of the mineral production rights would have been the purchase of an interest in real property and the "purchase" of the revenue stream is not, the purchase may not be authorized or appropriate under the provisions of Senate Bill 495. Potential consequences of these issues are discussed below.

As discussed in the previous section, the mineral royalty revenue received from lands owned by the trust must be deposited in the trust. Because the mineral production rights are still owned by the trust, the royalty revenue may have been inappropriately diverted from the trust.

The Code Commissioner issued a letter opinion dated April 30, 2001 that the provisions of section 77-1-109, MCA, cannot apply to the mineral production rights held by the department pursuant to section 4 of Senate Bill 495. This opinion also says, "Because the provisions of section 77-1-109, MCA, cannot be complied with, the department should not deduct mineral royalties from the production rights purchased pursuant to section 4 of Senate Bill No. 495 for the purpose of funding the trust land administration account provided for in section 77-1-108, MCA."

Senate Bill 495 has been challenged in Montana First Judicial District Court, Lewis and Clark County. The plaintiff alleges the sale and distribution of trust assets violate the Constitution and the Enabling Act of Montana.

The final resolution of these issues could have a material impact on the department, the school trust, the state general fund, and the funding of the department's trust land administrative activities. Additional research, and potentially court decisions or other interpretations of the law may be necessary to fully resolve these issues. As such they are presented here for disclosure purposes only.

Independent Auditor's Report & Agency Financial Schedules

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel

Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Schedules of Changes in Fund Balances & Property Held in Trust, Schedules of Total Revenues & Transfers-In, and Schedules of Total Expenditures & Transfers-Out of the Department of Natural Resources and Conservation for each of the fiscal years ended June 30, 2001 and 2002. The information contained in these financial schedules is the responsibility of the department's management. Our responsibility is to express an opinion on these financial schedules based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosure in the financial schedules. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in note 1, the financial schedules are presented on a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The schedules are not intended to be a complete presentation and disclosure of the department’s assets, liabilities, and cash flows.

In fiscal year 2002, the department recorded expenditures instead of a direct entry to fund balance for trust land balances to reflect the change from a Proprietary Fund classification to a Governmental Fund classification as required by state accounting policy. As a result, Direct Entries to Fund Balance are understated and NonBudgeted Expenditures are overstated by $51,260,371, respectively in the Permanent Fund on the Schedule of Changes in Fund Balances & Property Held in Trust for the fiscal year ended June 30, 2002. Other Expenses for the Permanent Fund and Nonbudgeted

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Expenditures & Transfers-Out are also overstated by $51,260,371 in the Trust Lands program on the Schedule of Total Expenditures & Transfers-Out for the fiscal year ended June 30, 2002.

In fiscal year 2002, the department incorrectly recorded the retirement of bonds as Debt Service - Bonds in one instance and as Accounting Entity Transfers in another instance. State accounting policy requires these transactions should be recorded as Benefits & Claims-Other Financing Uses. As a result Debt Service – Bonds are overstated by $12,278,873, Accounting Entity Transfers are overstated by $22,476,186 and Benefits & Claims – Other Financing Uses are understated by $34,755,059, respectively, in the Conservation Resource Development Division program on the Schedule of Total Expenditures & Transfers–Out for the fiscal year ended June 30, 2002.

In fiscal year 2001, the department incorrectly coded transfers to the Water Resources Division program instead of the Conservation Resource Development program. As a result of the coding errors, Accounting Entity Transfers are overstated in the Water Resources Division program and understated in the Conservation Resource Development Division program by $3,682,999, respectively, on the Schedule of Total Expenditures & Transfers-Out for the fiscal year ended June 30, 2001.

In our opinion, except for the effect of the items discussed in the three preceding paragraphs, the financial schedules referred to above present fairly, in all material respects, the results of operations and changes in fund balances of the Department of Natural Resources and Conservation for each of the fiscal years ended June 30, 2001 and 2002, in conformity with the basis of accounting described in note 1.

Respectfully submitted,

(Signature on File)

James Gillett, CPA
Deputy Legislative Auditor

September 13, 2002

DEPARTMENT OF NATURAL RESOURCES AND CONSERVATION
SCHEDULE OF CHANGES IN FUND BALANCES & PROPERTY HELD IN TRUST
FOR THE FISCAL YEAR ENDED JUNE 30, 2002

	General Fund	Special Revenue Fund	Debt Service Fund	Internal Service Fund	Agency Fund	Permanent Fund
FUND BALANCE: July 1, 2001	$ (11,278,070)	$ 122,787,575	$ 49,042,371	$ 225,230	$ 0	$ 417,527,079
PROPERTY HELD IN TRUST: July 1, 2001					$ 1,979,331	
ADDITIONS						
Budgeted Revenues & Transfers-In	3,908,743	101,523,258		820,498		
NonBudgeted Revenues & Transfers-In	58,510	72,086,801	33,889,991			153,022,947
Prior Year Revenues & Transfers-In Adjustments	(1,522,147)	862,607	(217,075)	13,945		(110,015)
Direct Entries to Fund Balance	33,488,206	(29,737,526)	295,256			204,374
Additions To Property Held in Trust					1,324,301	
Total Additions	35,933,312	144,735,140	33,968,172	834,443	1,324,301	153,117,306
REDUCTIONS						
Budgeted Expenditure & Transfers-Out	30,063,222	30,397,860		863,595		
NonBudgeted Expenditure & Transfers-Out	20,348	132,024,948	29,856,649	16,157		149,404,804
Prior Year Expenditure & Transfers-Out Adjustments	(3,213,291)	(170,062)		4,234		(2,489,462)
Reductions in Property Held in Trust					1,278,035	
Total Reductions	26,870,279	162,252,746	29,856,649	883,986	1,278,035	146,915,342
FUND BALANCE: June 30, 2002	$ (2,215,037)	$ 105,269,969	$ 53,153,894	$ 175,687	$ 0	$ 423,729,043
PROPERTY HELD IN TRUST: June 30, 2002					$ 2,025,597	

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

DEPARTMENT OF NATURAL RESOURCES AND CONSERVATION
SCHEDULE OF CHANGES IN FUND BALANCES & PROPERTY HELD IN TRUST
FOR THE FISCAL YEAR ENDED JUNE 30, 2001

	General Fund	Special Revenue Fund	Debt Service Fund	Capital Projects Fund	Internal Service Fund	Agency Fund	Nonexpendable Trust Fund
FUND BALANCE: July 1, 2000	$ 6,522,817	$ 97,900,902	$ 47,220,540	$ 0	$ 147,146	$ 0	$ 390,388,229
PROPERTY HELD IN TRUST: July 1, 2000						$ 2,785,704	
ADDITIONS							
Budgeted Revenues & Transfers-In	53,677,590	25,742,782			1,089,131		
NonBudgeted Revenues & Transfers-In	52,948	69,329,499	14,509,747				128,245,364
Prior Year Revenues & Transfers-In Adjustments	525	640,863	475,139		17,873		
Direct Entries to Fund Balance	857,501	6,684,779	278,615	8			2,973
Additions To Property Held in Trust						1,248,113	
Total Additions	54,588,564	102,397,923	15,263,501	8	1,107,004	1,248,113	128,248,337
REDUCTIONS							
Budgeted Expenditure & Transfers-Out	72,345,537	24,646,305		8	1,037,234		
NonBudgeted Expenditure & Transfers-Out		52,769,312	13,407,598		(1,839)		101,109,487
Prior Year Expenditure & Transfers-Out Adjustments	43,914	95,633	34,072		(6,475)		
Reductions in Property Held in Trust						2,054,486	
Total Reductions	72,389,451	77,511,250	13,441,670	8	1,028,920	2,054,486	101,109,487
FUND BALANCE: June 30, 2001	$ (11,278,070)	$ 122,787,575	$ 49,042,371	$ 0	$ 225,230	$ 0	$ 417,527,079
PROPERTY HELD IN TRUST: June 30, 2001						$ 1,979,331	

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

DEPARTMENT OF NATURAL RESOURCES AND CONSERVATION
SCHEDULE OF TOTAL REVENUES & TRANSFERS-IN
FOR THE FISCAL YEAR ENDED JUNE 30, 2002

	General Fund	Special Revenue Fund	Debt Service Fund	Internal Service Fund	Permanent Fund	Total
TOTAL REVENUES & TRANSFERS-IN BY CLASS						
Licenses and Permits	$ 3,397	$ 278,022			$ 907,391	$ 1,188,810
Taxes	7,188	2,159,637				2,166,825
Charges for Services	4,598,640	2,707,489	$ 1,139	$ 445,274		7,752,542
Investment Earnings		2,359,347	5,337,824		36,681,229	44,378,400
Fines and Forfeits	5,872	10,000				15,872
Sale of Documents, Merchandise and Property		2,986,652	2,071,733		6,487,679	11,546,064
Rentals, Leases and Royalties	11,423	34,102			23,722,145	23,767,670
Miscellaneous	1,301	21,888	41,424		8,636	73,249
Grants, Contracts, Donations and Abandonments		358,325				358,325
Other Financing Sources	(2,182,715)	158,993,100	26,220,796	389,169	85,105,852	268,526,202
Federal		4,436,620				4,436,620
Federal Indirect Cost Recoveries		127,484				127,484
Total Revenues & Transfers-In	2,445,106	174,472,666	33,672,916	834,443	152,912,932	364,338,063
Less: Nonbudgeted Revenues & Transfers-In	58,510	72,086,801	33,889,991		153,022,947	259,058,249
Prior Year Revenues & Transfers-In Adjustments	(1,522,147)	862,607	(217,075)	13,945	(110,015)	(972,685)
Actual Budgeted Revenues & Transfers-In	3,908,743	101,523,258	0	820,498	0	106,252,499
Estimated Revenues & Transfers-In	400,453	105,183,897		940,556		106,524,906
Budgeted Revenues & Transfers-In Over (Under) Estimated	$ 3,508,290	$ (3,660,639)	$ 0	$ (120,058)	$ 0	$ (272,407)
BUDGETED REVENUES & TRANSFERS-IN OVER (UNDER) ESTIMATED BY CLASS						
Licenses and Permits		$ 44,022				$ 44,022
Taxes		(43,806)				(43,806)
Charges for Services	$ 3,512,668	(731,473)		$ (153,808)		2,627,387
Investment Earnings		(433,369)				(433,369)
Fines and Forfeits	(4,378)	(30,000)				(34,378)
Sale of Documents, Merchandise and Property		94,952				94,952
Miscellaneous		(963)				(963)
Grants, Contracts, Donations and Abandonments		(1,268,967)				(1,268,967)
Other Financing Sources		(1,107,702)		33,750		(1,073,952)
Federal		(230,671)				(230,671)
Federal Indirect Cost Recoveries		47,338	$		$	47,338
Budgeted Revenues & Transfers-In Over (Under) Estimated	$ 3,508,290	$ (3,660,639)	$ 0	$ (120,058)	$ 0	$ (272,407)

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A-11.

DEPARTMENT OF NATURAL RESOURCES AND CONSERVATION
SCHEDULE OF TOTAL REVENUES & TRANSFERS-IN
FOR THE FISCAL YEAR ENDED JUNE 30, 2001

	General Fund	Special Revenue Fund	Debt Service Fund	Internal Service Fund	Nonexpendable Trust Fund	Total
TOTAL REVENUES & TRANSFERS-IN BY CLASS						
Licenses and Permits	$ 9,187	$ 253,366			$ 759,550	$ 1,022,103
Taxes	12,539	1,979,392				1,991,931
Charges for Services	6,843,260	3,175,855		$ 751,585		10,770,700
Investment Earnings		2,673,378	$ 4,722,301		42,560,967	49,956,646
Fines and Forfeits	3,365	20,000				23,365
Sale of Documents, Merchandise and Property		2,548,571	2,786,827		5,257,115	10,592,513
Rentals, Leases and Royalties	16,106	63,115			35,656,364	35,735,585
Miscellaneous	711	18,046				18,757
Grants, Contracts, Donations and Abandonments		1,312,109				1,312,109
Other Financing Sources	46,845,895	80,346,078	7,475,758	355,419	44,011,368	179,034,518
Federal		3,236,397				3,236,397
Federal Indirect Cost Recoveries		86,837				86,837
Total Revenues & Transfers-In	53,731,063	95,713,144	14,984,886	1,107,004	128,245,364	293,781,461
Less: Nonbudgeted Revenues & Transfers-In	52,948	69,329,499	14,509,747		128,245,364	212,137,558
Prior Year Revenues & Transfers-In Adjustments	525	640,863	475,139	17,873		1,134,400
Actual Budgeted Revenues & Transfers-In	53,677,590	25,742,782	0	1,089,131	0	80,509,503
Estimated Revenues & Transfers-In	42,829,287	25,383,101		649,209		68,861,597
Budgeted Revenues & Transfers-In Over (Under) Estimated	$ 10,848,303	$ 359,681	$ 0	$ 439,922	$ 0	$ 11,647,906
BUDGETED REVENUES & TRANSFERS-IN OVER (UNDER) ESTIMATED BY CLASS						
Licenses and Permits		$ 28,916				$ 28,916
Taxes		(90,488)				(90,488)
Charges for Services	$ 6,424,294	287,362		$ 480,392		7,192,048
Investment Earnings		79,553				79,553
Fines and Forfeits	(5,886)	(20,000)				(25,886)
Sale of Documents, Merchandise and Property		(46,135)				(46,135)
Miscellaneous		2,503				2,503
Grants, Contracts, Donations and Abandonments		(320,489)				(320,489)
Other Financing Sources	4,429,895	619,507		(40,470)		5,008,932
Federal		(161,087)				(161,087)
Federal Indirect Cost Recoveries		(19,961)	$		$	(19,961)
Budgeted Revenues & Transfers-In Over (Under) Estimated	$ 10,848,303	$ 359,681	$ 0	$ 439,922	$ 0	$ 11,647,906

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A - 11

DEPARTMENT OF NATURAL RESOURCES AND CONSERVATION
SCHEDULE OF TOTAL EXPENDITURES & TRANSFERS-OUT
FOR THE FISCAL YEAR ENDED JUNE 30, 2002

PROGRAM EXPENDITURES & TRANSFERS-OUT BY OBJECT	ADMIN FINANCIAL SERV DIVISION	CENTRALIZED SERVICES	CONSERVATION/ RESOURCE DEV DIV	FORESTRY/ TRUST LANDS	OIL & GAS CONSERVATION DIV.	R05	R06	RESERVED WATER RIGHTS COMP COM	TRUST FUNDS	WATER RESOURCES DIVISION	Total
Personal Services											
Salaries		$ 1,527,586	$ 850,499	$ 8,918,125	$ 572,645			$ 452,953		$ 4,014,289	$ 16,336,097
Hourly Wages				3,500,607							3,500,607
Other Compensation			650		6,000			5,239		400	12,289
Employee Benefits		345,897	213,844	2,764,267	149,505			107,302		1,058,884	4,639,699
Personal Services-Other				15,372							15,372
Total		1,873,483	1,064,993	15,198,371	728,150			565,494		5,073,573	24,504,064
Operating Expenses											
Other Services		346,890	806,621	10,482,769	153,939			39,018		2,139,750	13,968,987
Supplies & Materials		99,257	67,029	2,089,617	36,357			40,899		198,258	2,531,417
Communications		93,012	41,677	411,067	40,419			15,555		165,745	767,475
Travel		25,528	82,433	371,997	31,340			26,894		112,112	650,304
Rent		155,839	51,031	3,009,304	15,117			34,020		447,448	3,712,759
Utilities		14,816	3,562	153,771	10,157			3,565		7,683	193,554
Repair & Maintenance		10,439	6,402	1,088,100	16,827			1,762		24,653	1,148,183
Other Expenses		70,651	66,230	251,374	27,998			8,709	51,277,522	704,840	52,407,324
Total		816,432	1,124,985	17,857,999	332,154			170,422	51,277,522	3,800,489	75,380,003
Equipment & Intangible Assets											
Equipment			55,260	771,649	22,314					8,250	857,473
Capital Leases-Equipment-Nonbu		20,348		61,815							82,163
Intangible Assets				75							75
Total		20,348	55,260	833,539	22,314					8,250	939,711
Capital Outlay											
Land & Interest In Land				354						265,337	265,691
Total				354						265,337	265,691
Local Assistance											
From State Sources			247,373								247,373
Total			247,373								247,373
Grants											
From State Sources			2,723,644	24,650							2,748,294
From Federal Sources										78,892	78,892
From Other Sources			29,663							25,783	55,446
Total			2,753,307	24,650						104,675	2,882,632
Benefits & Claims											
To Individuals			500,000								500,000
Total			500,000								500,000
Transfers											
Accounting Entity Transfers			92,919,962	389,169		$ 263,897	(6)		141,757,978		235,331,000
Total			92,919,962	389,169		263,897	(6)		141,757,978		235,331,000
Debt Service											
Bonds	$ 82,050		22,754,050							2,938	22,839,038
Loans				3,470,611						388,652	3,859,263
Leases		257		12,720							12,977
Lease Participation Notes			17,250								17,250
Total	82,050	257	22,771,300	3,483,331						391,590	26,728,528
Total Program Expenditures & Transfers-Out	$ 82,050	$ 2,710,520	$ 121,437,180	$ 37,787,413	$ 1,082,618	$ 263,897	$ (6)	$ 735,916	$ 193,035,500	$ 9,643,914	$ 366,779,002

PROGRAM EXPENDITURES & TRANSFERS-OUT BY FUND	ADMIN FINANCIAL SERV DIVISION	CENTRALIZED SERVICES	CONSERVATION/ RESOURCE DEV DIV	FORESTRY/ TRUST LANDS	OIL & GAS CONSERVATION DIV.	R05	R06	RESERVED WATER RIGHTS COMP COM	TRUST FUNDS	WATER RESOURCES DIVISION	Total
General Fund		$ 1,887,527	$ 2,122,948	$ 16,111,067				$ 720,916		$ 6,027,821	$ 26,870,279
Special Revenue Fund		822,208	89,542,571	20,793,145	$ 1,082,618		$ (6)	15,000	46,384,055	3,613,155	162,252,746
Debt Service Fund	$ 82,050		29,771,661							2,938	29,856,649
Internal Service Fund		785		883,201							883,986
Permanent Fund						$ 263,897			146,651,445		146,915,342
Total Program Expenditures & Transfers-Out	82,050	2,710,520	121,437,180	37,787,413	1,082,618	263,897	(6)	735,916	193,035,500	9,643,914	366,779,002
Less: Nonbudgeted Expenditures & Transfers-Out	82,050	21,133	115,353,768	46,525		263,897	(6)		195,524,962	30,573	311,322,902
Prior Year Expenditures & Transfers-Out Adjustments		2,311	(200,406)	(3,187,974)	(27,673)			439	(2,489,462)	34,185	(5,868,580)
Actual Budgeted Expenditures & Transfers-Out	0	2,687,076	6,283,818	40,928,862	1,110,291	0	0	735,477	0	9,579,156	61,324,680
Budget Authority		2,867,557	14,568,365	116,192,108	2,290,165			755,594		15,703,603	152,377,392
Unspent Budget Authority	$ 0	$ 180,481	$ 8,284,547	$ 75,263,246	$ 1,179,874	$ 0	$ 0	$ 20,117	$ 0	$ 6,124,447	$ 91,052,712

UNSPENT BUDGET AUTHORITY BY FUND	ADMIN FINANCIAL SERV DIVISION	CENTRALIZED SERVICES	CONSERVATION/ RESOURCE DEV DIV	FORESTRY/ TRUST LANDS	OIL & GAS CONSERVATION DIV.	R05	R06	RESERVED WATER RIGHTS COMP COM	TRUST FUNDS	WATER RESOURCES DIVISION	Total
General Fund		$ 49,927	$ 29,220	$ 230,307				$ 20,117		$ 62,686	$ 392,257
Special Revenue Fund		130,554	8,255,327	74,914,706	$ 1,179,874					6,061,761	90,542,222
Internal Service Fund				118,233							118,233
Unspent Budget Authority	$ 0	$ 180,481	$ 8,284,547	$ 75,263,246	$ 1,179,874	$ 0	$ 0	$ 20,117	$ 0	$ 6,124,447	$ 91,052,712

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A - 11

DEPARTMENT OF NATURAL RESOURCES AND CONSERVATION
SCHEDULE OF TOTAL EXPENDITURES & TRANSFERS-OUT
FOR THE FISCAL YEAR ENDED JUNE 30, 2001

	No Program Specified (Note 4)	CENTRALIZED SERVICES	CONSERVATION/ RESOURCE DEVELOPMENT DIVISION	FORESTRY & TRUST LANDS	OIL & GAS CONSERVATION DIVISION	RESERVED WATER RIGHTS COMP COM	STATE COMPENSATION MUTUAL INSURANCE FUND	TRUST FUNDS	WATER RESOURCES DIVISION	Total
PROGRAM EXPENDITURES & TRANSFERS-OUT BY OBJECT										
Personal Services										
Salaries		1,356,922	$ 837,838	$ 14,917,192	$ 543,750	$ 400,636			$ 3,669,583	$ 21,725,921
Hourly Wages				264,192						264,192
Other Compensation			625		5,450	1,300			300	7,675
Employee Benefits		313,037	210,743	2,796,714	142,460	99,107			947,834	4,509,895
Personal Services-Other				(2,623)						(2,623)
Total		1,669,959	1,049,206	17,975,475	691,660	501,043			4,617,717	26,505,060
Operating Expenses										
Other Services		249,903	575,959	39,116,278	805,804	104,553			2,718,923	43,571,420
Supplies & Materials		155,340	56,450	3,309,051	35,149	9,677			260,907	3,826,574
Communications		45,851	39,385	397,344	40,274	7,770			141,934	672,558
Travel		18,634	83,141	471,160	29,945	16,040			144,041	762,961
Rent		138,860	48,899	8,294,086	15,902	32,034			410,792	8,940,573
Utilities		16,827	3,844	186,295	10,902	4,042			7,918	229,828
Repair & Maintenance		5,398	6,805	1,685,722	14,392	3,570			38,494	1,754,381
Other Expenses	$ 785	25,199	75,634	280,766	25,160	6,413		$ 85,045	181,644	680,646
Total	785	656,012	890,117	53,740,702	977,528	184,099		85,045	3,904,653	60,438,941
Equipment & Intangible Assets										
Equipment		3,616	21,848	507,104	14,592				33,664	580,824
Total		3,616	21,848	507,104	14,592				33,664	580,824
Capital Outlay										
Land & Interest In Land				1,031					70	1,101
Total				1,031					70	1,101
Local Assistance										
From State Sources			221,000							221,000
Total			221,000							221,000
Grants										
From State Sources		574,817	7,149,192	562,482					94,392	8,380,883
From Federal Sources									76,208	76,208
Total		574,817	7,149,192	562,482					170,600	8,457,091
Benefits & Claims										
To Individuals			1,500,000							1,500,000
Total			1,500,000							1,500,000
Transfers										
Accounting Entity Transfers			53,123,312	355,419			$ 196,850	101,109,487	3,682,999	158,468,067
Total			53,123,312	355,419			196,850	101,109,487	3,682,999	158,468,067
Debt Service										
Bonds			9,774,131						218,124	9,992,255
Loans									399,351	399,351
Leases				20,856						20,856
Installment Purchases			(1,103,760)							(1,103,760)
Total			8,670,371	20,856					617,475	9,308,702
Total Program Expenditures & Transfers-Out	$ 785	$ 2,904,404	$ 72,625,046	$ 73,163,069	$ 1,683,780	$ 685,142	$ 196,850	$ 101,194,532	$ 13,027,178	$ 265,480,786
PROGRAM EXPENDITURES & TRANSFERS-OUT BY FUND										
General Fund		$ 2,443,274	$ 2,934,377	$ 60,690,664		$ 600,142			$ 5,720,994	$ 72,389,451
Special Revenue Fund		461,130	56,554,740	11,444,262	$ 1,683,780	85,000	$ 196,850	$ 85,045	7,000,443	77,511,250
Debt Service Fund			13,135,929						305,741	13,441,670
Capital Projects Fund				8						8
Internal Service Fund	$ 785			1,028,135						1,028,920
Nonexpendable Fund								101,109,487		101,109,487
Total Program Expenditures & Transfers-Out	785	2,904,404	72,625,046	73,163,069	1,683,780	685,142	196,850	101,194,532	13,027,178	265,480,786
Less: Nonbudgeted Expenditures & Transfers-Out	(32,824)		61,589,631	17,426			196,850	101,194,532	4,318,943	167,284,558
Prior Year Expenditures & Transfers-Out Adjustments	33,609	877	79,628	45,630	2,639	(675)			5,434	167,142
Actual Budgeted Expenditures & Transfers-Out	0	2,903,527	10,955,787	73,100,013	1,681,141	685,817	0	0	8,702,801	98,029,086
Budget Authority		3,198,805	12,011,793	75,882,978	1,899,913	761,548			10,484,069	104,239,106
Unspent Budget Authority	$ 0	$ 295,278	$ 1,056,006	$ 2,782,965	$ 218,772	$ 75,731	$ 0	$ 0	$ 1,781,268	$ 6,210,020
UNSPENT BUDGET AUTHORITY BY FUND										
General Fund		$ 57,174	$ 72,038	$ 135,752		$ 60,731			$ 165,073	$ 490,768
Special Revenue Fund		238,104	983,968	2,537,781	$ 218,772	15,000			1,616,195	5,609,820
Capital Projects Fund				48						48
Internal Service Fund				109,384						109,384
Unspent Budget Authority	$ 0	$ 295,278	$ 1,056,006	$ 2,782,965	$ 218,772	$ 75,731	$ 0	$ 0	$ 1,781,268	$ 6,210,020

This schedule is prepared from the Statewide Accounting, Budgeting, and Human Resources System (SABHRS) without adjustment. Additional information is provided in the notes to the financial schedules beginning on page A - 11

1. Summary of Significant Accounting Policies

Basis of Accounting

The department uses the modified accrual basis of accounting, as defined by state accounting policy, for its Governmental and Agency Funds. In applying the modified accrual basis, the department records:

Revenues when it receives cash or when receipts are measurable and available to pay current period liabilities.

Expenditures for valid obligations when the department incurs the related liability and it is measurable, with the exception of the cost of employees' annual and sick leave. State accounting policy requires the department to record the cost of employees' annual leave and sick leave when used or paid.

The department uses accrual basis accounting for Internal Service and Permanent Trust/Nonexpendable Trust Funds. Under the accrual basis, as defined by state accounting policy, the department records revenues in the accounting period earned when measurable and records expenses in the period incurred when measurable.

Expenditures and expenses may include: entire budgeted service contracts even though the department receives the services in a subsequent fiscal year; goods ordered with a purchase order before fiscal year-end, but not received as of fiscal year-end; and equipment ordered with a purchase order before fiscal year-end.

Basis of Presentation

The financial schedule format is in accordance with the policy of the Legislative Audit Committee. The financial schedules are prepared from the transactions posted to the state's accounting system without adjustment. As described in note 7 on page A-15, the financial schedules reflect the retroactive application of the requirements of Chapter 10, Laws of 2002.

The 2001 Legislature modified the fund structure established in section 17-2-102, MCA, to implement changes made to GAAP by the Governmental Accounting Standards Board (GASB) Statement 34. These changes were effective July 1, 2001. Department accounts are organized in funds according to state law. The department uses the following funds.

Governmental Funds

General Fund - to account for all financial resources except those required to be accounted for in another fund.

Special Revenue Fund - to account for proceeds of specific revenue sources legally restricted to expenditures for specific purposes. The department has several State Special Revenue Funds that account for activities. These include Forestry Operations, Wastewater Projects, Drinking Water Projects, and Renewable Resource Grants and Loans Program. The department's Federal Special Revenue Funds account for money provided to the state from federal agencies. Fire suppression efforts were federal projects at the department during the audit period.

Debt Service Fund - to account for accumulated resources for the payment of general long-term debt principal and interest. The department uses this fund for the bonds issued to provide funding for Renewable Resources, Coal Severance Tax, and water development projects.

Capital Projects Fund - to account for resources used for the acquisition or construction of major capital facilities, other than those financed by proprietary funds or trust fund. The long range building projects account is used for repair and maintenance of the various state-owned facilities used by the department.

Permanent Fund - to account for financial resources that are legally restricted to the extent that only earnings, and not principal, may be used for purposes that support the department's programs. In fiscal year 2001, this activity was reported under the Nonexpendable Trust Fund. The department uses this fund for the Common School Permanent Trust, University and College Trusts, Morrill Permanent

Trust, Deaf and Blind Permanent Trust, Pine Hills School Permanent Trust, Capitol Building Trust, and the Trust and Legacy account.

Proprietary Funds

Internal Service Fund - to account for providing goods or services to other agencies or departments on a cost-reimbursement basis. The Forestry Division, Air Operations Bureau maintains and operates aircraft to aid in fire suppression and is the only Internal Service Fund at the department.

Fiduciary Funds

Agency Funds - to account for resources held by the State in a custodial capacity. The department Agency Funds account for activity such as protested oil and gas royalties, non-land grant interest and income, and hazard reduction.

2. General Fund Balance

The negative fund balance in the General Fund does not indicate overspent appropriation authority. Each agency has authority to pay obligations from the statewide General Fund within its appropriation limits. Each agency expends cash or other assets from the statewide fund when it pays General Fund obligations. The department's outstanding liabilities exceed the assets the agency has placed in the fund, resulting in negative ending General Fund balances for each of the two fiscal years ended June 30, 2001 and June 30, 2002.

3. Direct Entries to Fund Balance/Cash Transfers

Direct entries to fund balance in the General, Special Revenue, Debt Service, and Permanent/Nonexpendable Trust funds in fiscal years 2000-01 and 2001-02 include entries generated by SABHRS to reflect the flow of resources within individual funds shared by separate agencies.

4. Expenditure Program (Subclass)

As part of the implementation of a new accounting system in fiscal year 1999-2000, state officials determined that a subclass designation would identify the program to which an expenditure should be charged. State officials did not require nonbudgeted expenditure transactions to be identified to a subclass. The program designations in the Schedules of Total Expenditures & Transfers-Out are based on the subclass designation used when the expenditures were recorded. The accounting system did not require agencies to code nonbudgeted accounts with a subclass code identifying the expenditure program in which the activity occurred until September 2000. This nonbudgeted activity is included in the column titled "No Program Specified" on the Schedule of Total Expenditures & Transfers-Out for the Fiscal Year Ended June 30, 2001. The Permanent Fund/Nonexpendable Trust Fund nonbudgeted activity relates to investment earnings and the Trust Fund program.

5. Long-Term Debt

During the audit period, the state of Montana issued general obligation bonds. A portion of the proceeds was used by the department to make loans related to drinking water, wastewater, water development or renewable resource projects. The following general obligation bonds related to the department were issued during the audit period. In fiscal year 2000-01, the department issued Series 2001E bonds for $1,040,000 for the Renewable Resource Program. In fiscal year 2001-02 the department issued Series 2001G bonds for $3,190,000 for water projects and Series 2001H bonds for $2,690,000 for wastewater treatment projects.

The department issued Coal Severance Tax (CST) 2001 Series A bonds for $420,000; 2001 Series B for $1,750,000; 2001 Refunding Series C for $12,155,000; 2001 Refunding Series D for $21,450,000; 2001 Series E for $885,000; and 2001 Series F for $900,000 during the audit period. These bonds were issued for the purpose of redeeming CST bond Series 1990A, 1992A, and 1992B and to fund loans. The loans are made to (1) political subdivisions within the state to finance water and wastewater products, (2) finance improvements to state-owned dams, or (3) fund additional loans to political subdivisions for such purposes. At June 30, 2002, the department had a total of $48,590,000 of CST bonds outstanding.

The department had a loan from the U.S. Bureau of Reclamation to fund the Middle Creek Dam project. The unpaid loan principal as of June 30, 2002, was $2,767,256.

The Northern Cheyenne Tribe and the department entered into an agreement on July 1, 1994, in which the tribe agreed to loan the state up to $11,500,000 of federal funds appropriated as part of the Northern Cheyenne Indian Reserved Water Rights Settlement. The loan was used to help finance the costs of the Tongue River Dam Project. The actual amount of the loan was $11,300,000. The loan is interest free, but the state must repay the principal amount of the loan in 39 equal and consecutive annual installments of $289,743 starting December 1, 1999. The outstanding principal balance at June 30, 2002, was $10,430,769.

6. Other Financing Sources

The Schedules of Total Revenues and Transfers-In contain substantial activity in the other financing sources class.

General Fund - Transfer-In of earnings from the Common School Permanent Trust Fund during FY 2000-01. As explained in Note 7, this activity is in the Special Revenue Fund in FY 2001-02.

Special Revenue Fund - A majority of this activity relates to Transfer-In of loans receivable from other funds and Transfer-In of federal funds from the Department of Environmental Quality for the Clean Water and Drinking Water State Revolving Funds.

7. Guarantee Account

Chapter 418, Laws of 2001, established a Guarantee Account for distributing the interest and income earnings from the Common School Permanent Trust Fund to school districts, effective July 1, 2001. The Guarantee Account was originally established as a sub-fund of the General Fund. Chapter 10, Laws of 2002, retroactively established the Guarantee Account as a Special Revenue Fund for fiscal year 2001-02. The financial activity reported on the Schedules of Changes in Fund Balances and Property Held in Trust, Schedule of Total Revenues & Transfers-In, and Schedule of Total Expenditures & Transfers-Out for the fiscal year ended June 30, 2002, reflects the retroactive applicability of Chapter 10, Laws of 2002. These schedules appear on pages A-5, A-7, and A-9 of the audit report, respectively.

At June 30, 2002, the Guarantee Account contained a negative ending fund balance of $(8,561,935). The office obtained an inter-entity loan from the General Fund in order to complete the required distributions from the Guarantee Account by June 30, 2002. The outstanding loan balance exceeded the available resources in the

Guarantee Account at June 30, 2002, by the amount of the negative ending fund balance.

Department Response

DNRC RESPONSE TO FY 01/02 LEGISLATIVE AUDIT

1) **We recommend the department:**

A) Record nonbudgeted expenditures activity in the proper subclass.
Concur. DNRC will monitor nonbudgeted subclass activity more closely and work with the Department of Administration to obtain proper edit controls over nonbudgeted subclass activity.

B) Work with the Department of Administration to establish SABHRS controls to prevent transactions with invalid department subclasses from posting to the accounting system.
Concur. DNRC will submit a request to the Department of Administration SABHRS unit, as well as discussions with the SABHRS Executive Council to get proper controls on nonbudgeted subclass activity.

2) **We recommend the department:**

A) Record accounting transactions in accordance with state law and policy
Concur. DNRC will comply with state law and the new accounting policy issued for GASB 34 when recording accounting transactions.

B) Implement an oversight procedure to detect and correct accounting errors
Concur. DNRC will provide additional oversight and review to our accounting records to help detect and correct errors.

3) **We recommend the department continue to work with the Department of Administration to develop accounting procedures for recording easements.**
Concur. DNRC will continue to work with the Department of Administration to develop a state policy that establishes clear guidelines and procedures for recording and capitalizing easements.

4) **We recommend the department properly record revenue in the accounting records by fiscal year-end to properly match revenue and expenditures in its federal funds.**
Concur. Federal revenues will be properly recorded to match expenditures at Fiscal Year end.

5) **We recommend the department:**

A) Establish a Board of Adjustment for each conservation district that has adopted an ordinance.
Concur. A Board of Adjustment will be established for each conservation district that has adopted a land use ordinance.

B) If necessary, seek legislation to eliminate or modify the board of adjustment requirement.

Concur. The department will pursue legislation that will clarify this requirement in the 2005 Legislative session.

6) **We recommend the department ensure payments received at field offices are deposited in accordance with state law and policy.**

Concur. DNRC will work with field offices to ensure understanding and compliance with the state and department policy concerning timely deposits. We will also monitor compliance with these policies as well.

7) **We recommend the department accurately and completely prepare its Schedule of Expenditures of Federal Awards.**

Concur. The department will establish procedures to ensure reconciliation of the Schedule of Expenditures of Federal Awards with expenditure data with our federal grants.

8) **We recommend the department establish procedures to complete the State Revolving Fund financial statements to ensure the audit report can be completed within one year as required by federal regulations.**

Concur. The department will provide the necessary resources and staffing to prepare the financial statements to ensure that the audit work can be completed within one year.

DRAFT RESPONSE NARRATIVE – DNRC FINANCIAL AUDIT
TAC and SB495 DISCLOSURE ISSUES

Moneys Placed in Trust Land Administration Account

The financial audit's review does not advise of any discrepancy between the department's implementation of, and the Legislature's intent for, the funding of the trust land administration account, as enacted and codified at 77-1-108 and –109, MCA. At enactment, the legislature was aware of the Code Commissioner's questions regarding the statute. The legislature was also aware of the preponderance of case law, Montana Attorney General opinions, and fundamental tenants of trust law, that all support the widely accepted ability of a trust manager to utilize a reasonable portion of gross revenue to cover management costs. All proceeds (the amount of revenue available after covering reasonable management costs) are placed into the appropriate trust. Trust beneficiary groups are active within Montana. The State and department have been the subject of past and current legal challenges to various aspects of the department's implementation of statute. However, even these groups have not challenged the core premise embodied in 77-108 and –109, MCA – that prudent trust management includes apportionment of a portion of gross revenue to cover reasonable and necessary trust management costs. Actions of the legislature are constitutional unless determined otherwise in court.

Senate Bill 495 Authorized Purchase of Mineral Rights

The department respectfully disagrees with the audit's position that a royalty interest is not equivalent to a mineral production right. During session, the department pointed out to bill proponents that the original language ("mineral rights") would not be appropriate since sale of mineral title is prohibited by Federal law, and that royalty proceeds were the only monetary interest flowing into the school trust permanent fund. Based on this, and in consultation with Legislative Services Division, the bill was specifically amended to refer to "mineral production rights" since, for a mineral owner, the royalty interest is the production right they realize from the sale of the mineral. In addition, fiscal note narrative and calculations are consistent with SB495's intention to utilize the royalty stream otherwise flowing to the common school permanent fund.

Respectfully, the audit's statement that a royalty interest is not a property right or an interest in real property is incorrect. As we previously advised, a mineral estate is real property, and the royalty interest is one element of the full bundle of rights that comprise the mineral estate. It is long established and widely recognized that a royalty interest is an interest in real property. Stokes v. Tutvet, 328 P.2d 1096 (Mont., 1958)

The department concurs, and is in compliance with, the audit statement that the provisions of 77-1-109, MCA do not apply to mineral production rights specified in section 4 of SB495, and that the trust land administration account should not be funded from SB495 mineral royalties. The mineral royalties purchased pursuant to SB495 are those common school mineral royalties that would otherwise (absent SB495) go to the common school permanent fund. For all time periods (pre- and post-SB495) these mineral royalties do not include the amount allocated for funding the trust administration account pursuant to 77-1-109, MCA.

In conclusion, the preliminary audit narrative correctly points out that SB495 is subject to pending legal action by a trust beneficiary group, but that action does not allege that the department's implementation is inconsistent with SB495. To the contrary, it alleges that the department is carrying out SB495 consistent with legislative intent and, in so doing, has implemented an action that the trust beneficiary group believes is not in the best interest of the trust.