



Washington State Auditor's Office

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Accountability Audit Report

Department of Natural Resources

For the period July 1, 2014 through June 30, 2015

Published November 14, 2016

Report No. 1017809





Washington State Auditor's Office

November 14, 2016

The Honorable Peter Goldmark, Commissioner of Public Lands
Department of Natural Resources
Olympia, Washington

Report on Accountability

Thank you for the opportunity to work with you to promote accountability, integrity and openness in government. The State Auditor's Office takes seriously our role of providing state and local governments with assurance and accountability as the independent auditor of public accounts. In this way, we strive to help government work better, cost less, deliver higher value and earn greater public trust.

Independent audits provide essential accountability and transparency for Department operations. This information is valuable to management, the governing body and public stakeholders when assessing the government's stewardship of public resources.

The attached comprises our report on the Department's compliance and safeguarding of public resources. Our independent audit report describes the overall results and conclusions for areas we examined. We appreciate the opportunity to work with your staff and we value your cooperation during the audit.

Sincerely,

A handwritten signature in cursive script that reads "Troy X. Kelley".

TROY KELLEY
STATE AUDITOR
OLYMPIA, WA

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AUDIT SUMMARY

Results in brief

In most areas we audited, Department operations complied with applicable requirements and provided adequate safeguarding of public resources. The Department also complied with state laws and regulations and its own policies and procedures in the areas we examined.

However, we identified an area in which the Department could make improvements. We found the Department did not establish adequate internal controls over its orchard and vineyard leases. We recommended the Department update its internal policies, provide training to staff and improve its review of expense deductions submitted by lessees.

We also noted certain matters that we communicated to Department management in a letter dated October 20, 2016, related to the use of purchase cards and sales tax paid on fire suppression service contracts. We appreciate the Department's commitment to resolving those matters.

About the audit

This report contains the results of our independent accountability audit of the Department of Natural Resources from July 1, 2014 through June 30, 2015.

Management is responsible for ensuring compliance and adequate safeguarding of public resources from fraud, loss or abuse. This includes the design, implementation and maintenance of internal controls relevant to these objectives.

Our audit involved performing procedures to obtain evidence about the Department's uses of public resources, compliance with state laws and regulations and its own policies and procedures, and internal controls over such matters.

In keeping with general auditing practices, we do not examine every transaction, activity or area. Instead, the areas examined were those representing the highest risk of fraud, loss, abuse, or noncompliance. The following areas were examined during this audit period:

- Orchard and vineyard contract and lease revenues
- Fire suppression contracts and expenditures
- Employee compensation (excluding salaries) and fringe benefits
- Purchase cards

SCHEDULE OF AUDIT FINDINGS AND RESPONSES

2015-001 The Department of Natural Resources did not establish adequate internal controls over its orchard and vineyard leases.

Background

The Department of Natural Resource's primary mission is to manage public lands. Some public lands are leased by the Department to private businesses who have established orchards and vineyards. The leases are established to ensure productive agricultural growth and sustainable land management. In fiscal year 2015, approximately 1.1 million acres of state lands were leased and generated revenue for the state.

Most lease terms are unique. For example, some leases stipulate a business will pay the Department cash rent, a percentage of crop share sales, or a combination of both. According to Department policy and individual lease terms, some leases allow for certain expense deductions. Allowable deductions, if supported by adequate documentation, reduce the lessee's gross sales. These allowable and supported expenses effectively reduce the lessee's crop share payment to the Department.

A Department policy describes what procedures should be performed to monitor lessees to ensure the Department receives the proper revenues and that the lessee complies with the terms and conditions of the lease.

In state fiscal year 2015, the Department collected approximately \$8.3 million that was generated through orchard and vineyard leases.

Description of Condition

We judgmentally selected and examined 31 orchard and vineyard leases, from which the Department collected revenues totaling \$2.4 million, to determine if what was collected aligned with the agreement. We also evaluated if deductions made by lessees were allowable and supported by adequate documentation.

We found the Department did not adequately monitor to ensure lessees complied with the lease terms. Specifically:

- The Department accepted crop reports from 11 lessees (35 percent) that contained crops that were not authorized.

- Monitoring visits for 28 leases (90 percent) were not performed by agricultural staff during the year to determine reasonable and expected crop production, and subsequent revenue collection.
- The Department did not complete a preliminary crop report for 28 leases (90 percent), as required by its own policy in order to estimate the expected crop revenues.
- For 10 leases (32 percent), the Department did not review expenses claimed by the lessees for allowability. Additionally, adequate supporting documentation such as receipts or invoices were not obtained to verify the accuracy of the expenses.

Cause of Condition

Current agricultural land management practices do not align with existing Departmental policies and guidance. The Department's policy was last updated in 1999.

We interviewed staff who said they have not been provided specific contract monitoring guidelines and current lease policies to assist them in their reviews. Staff also said that, due to the considerable turnover within the agricultural land management unit, the Department was unable to monitor the orchard and vineyard land leases program on a yearly basis.

Effect of Condition

By not establishing adequate internal controls, the Department is at a higher risk of not receiving all revenues it is entitled to. There is also an increased risk that lessees are not compliant with the terms and conditions of lease agreements.

As a result of the conditions listed above, we calculated the Department may not have collected an additional \$259,236 in revenues from lessees.

Recommendations

We recommend the Department improve its internal controls over the orchard and vineyard leases program. Specifically, we recommend the Department:

- Update and follow internal policies related to orchard and vineyard leases.
- Ensure staff at regional offices receive adequate training regarding required orchard and vineyard revenue reconciliations, and lessee's expense deductions.

- Review the unsupported expense deductions identified by the audit and determine if the lessees under paid the Department.

Department's Response

The State Auditor's Office (SAO) concluded that DNR was not adhering to Agency policy. For clarity, the record should show that DNR had not correctly followed an agency procedure. DNR generally agrees with most aspects of the audit findings with regards to Conditions and Recommendations.

DNR manages state trust lands to produce revenue for our trust beneficiaries (primarily schools). In particular, the agency has expended a great deal of effort over the past 5 years in bringing rents to Fair Market Value in the Agriculture program. For example, in FY 2010, the agriculture lands generated approximately \$14 million per year. In FY 2016, we generated approximately \$24 million in revenue off these same lands. Although these are impressive numbers, we know there is still room to improve our practices. This audit has brought some of those issues to our attention. DNR strives and will continue to strive towards transitioning all crop share leases to cash leases. This has been successful over the past 5 years, and DNR now has converted almost half (44%) of its orchard and vineyard leases to cash rent. We anticipate this trend to continue.

The referenced procedure, PR08-03-007m, is out of date and does not reflect our current business practices. DNR will revise the procedure to ensure better accountability moving forward. The procedure will continue to require field inspections of sites and will also address methods found in this report to help better document and justify expenses. For example:

- *Describing reasonable and customary crop production expenses that are allowable deductions from revenues or return to grower. Most existing contracts are long-term, and contain variations of language – sometimes vague. New contracts will be written to avoid these ambiguities.*
- *Describing a method to ensure that allowable production costs are appropriate for the different types of producers, and consistently interpret expenses from the various warehouses. The ordinary and necessary costs of operating a farm for profit are deductible business expenses. "Ordinary" means what most farmers do and "necessary" means what is useful and helpful in farming.*

- *Implement a system that ensures that we are only allowing ordinary and necessary costs consistent with typical industry trends and that we are receiving revenue reflective of the market conditions.*
- *We recognize that in some situations, harvest reports were not provided to DNR by the lessee per the contractual due date. There are instances when expenses for a particular crop year may have been incurred and deducted during a different year. DNR will look into each percentage crop share lease for orchards and vineyards and develop an internal tracking tool to ensure compliance. We will also send letters tailored to each lessee outlining the provisions of the lease and future expectations and enforcement of the contract.*

We will ensure staff follows up on comments and recommendations for each lease as provided by the SAO. If, after investigation, corrective action is needed to correct lease specifications (change in use or acreages) or collect additional revenue, we will do so.

In addition to developing the procedures outlined above, DNR will put in place a plan to address training gaps with employees to ensure compliance with new or revised procedures.

DNR intends to have these issues rectified and future direction in place no later than May 31, 2017.

Auditor's Remarks

We appreciate the Department's response and will follow-up on the Department's corrective action in a future audit.

Applicable Laws and Regulations

RCW 79.13.030 Lease contents

Every lease issued by the department must contain:

- (1) The specific use or uses to which the land is to be employed;
- (2) The improvements required, if any;
- (3) Provisions providing that the rent is payable in advance in quarterly, semiannual, or annual payments as determined by the department, or as agreed upon by the lessee and the department;

(4) Other terms and conditions as the department deems advisable, subject to review by the board, to achieve the purposes of the state Constitution and this chapter.

RCW 79.13.040 Inspections—Surveys

(1) When in the judgment of the department there is sufficient interest for the lease of state lands, it must inspect each tract of land as to its topography, development potential, forestry, agricultural, and grazing qualities; the presence of coal, mineral, stone, gravel, or other valuable materials; the distance from any city or town, railroad, river, irrigation canal, ditch, or other waterway; and location of utilities.

(2) The department may survey any state lands to determine the area subject to lease.

(3) It is the duty of the department to prepare all reports, data, and information in its records pertaining to any proposed lease.

(4) The department may order that any particular application for a lease be held in abeyance pending further inspection and report by the department. Based on the further inspection and report, the department must determine whether or not, and the terms upon which, the proposed lease is consummated.

RCW 79.13.180 Record of leases

The department shall keep a full and complete record of all leases issued under the provisions of the preceding sections and the payments made thereon.

RCW 79.13.320 Share crop leases authorized.

The department may lease state lands on a share crop basis. Upon receipt of a written application to lease state lands, the department shall make such investigations as it deems necessary. If the department finds that such a lease would be advantageous to the state, it may proceed with the leasing of such lands on such terms and conditions as other state lands are leased.

RCW 79.13.330 Harvest, storage of crop – Notice – Warehouse receipt.

When crops that are covered by a share crop lease are harvested, the lessee shall give written notice to the department that the crop is being harvested, and shall also give to the department the name and address of the warehouse or elevator to which such crops are sold or in which such crops will be stored. The lessee shall also serve on the owner of such warehouse or elevator a written copy of so much of the lease as shall show the percentage of division of the proceeds of such crop as between lessee and lessor. The owner of such warehouse or elevator shall make out a warehouse receipt, which receipt may be negotiable or nonnegotiable as directed by the state, showing the percentage of crops belonging to the state, and the respective gross and net amounts, grade, and location thereof, and shall deliver to the department the receipt for the state's percentage of such crops within ten days after the owner has received such instructions.

WAC 332-22-050 Lease procedure – Amendment

Existing leases may be amended through negotiation between the lessee and the department but the term of any such amendment shall not exceed the specified maximum lease period as set forth in RCW 79.01.096 or 79.12.570. Such amendments shall be in writing and signed by both parties.

WAC 332-22-060 Lease procedure – Rental adjustments.

All leases shall provide for periodic rental reevaluation and adjustment, except leases with rentals based upon a percentage of crop or income. The lessee may request rental adjustments as provided in RCW 79.01.096.

WAC 332-22-105 Initial lease for commercial, industrial, or residential uses by negotiation.

(1) The department may negotiate initial leases to authorize commercial, industrial, or residential uses on specific parcels of land zoned for such uses provided:

(a) Not more than one application is received by the department to lease the property.

(b) The department determines that a rent of at least fair market rental can be obtained through negotiation.

(c) The department publishes a notice of intent to lease which contains the legal description and zoning of the property, the office to which application to lease can be made, and the final date to submit a written request to lease. The notice shall be published not more than thirty days nor less than twenty days immediately preceding commencement of negotiation in two newspapers of general circulation in the locality of the state land, one of which shall be in the county where the land is located.

(d) The department shall report to the board of natural resources on each initial lease entered into by negotiation. The report shall include the fair market value of the property, rental and lease terms.

(2) The department may negotiate initial leases at fair market rental to authorize placement and maintenance of communication equipment in or on electronic site buildings and on electronic site towers.

RCW 43.88.160 Fiscal management – Powers and duties of officers and agencies. states in part:

This section sets forth the major fiscal duties and responsibilities of officers and agencies of the executive branch. The regulations issued by the governor pursuant to this chapter shall provide for a comprehensive, orderly basis for fiscal management and control, including efficient accounting and reporting therefor, for the executive branch of the state government and may include, in addition, such requirements as will generally promote more efficient public management in the state.

(1) Governor; director of financial management. The governor, through the director of financial management, shall devise and supervise a modern and complete accounting system for each agency to the end that all revenues, expenditures, receipts, disbursements, resources, and obligations of the state shall be properly and systematically accounted for. The accounting system shall include the development of accurate, timely

records and reports of all financial affairs of the state. The system shall also provide for central accounts in the office of financial management at the level of detail deemed necessary by the director to perform central financial management. The director of financial management shall adopt and periodically update an accounting procedures manual. Any agency maintaining its own accounting and reporting system shall comply with the updated accounting procedures manual and the rules of the director adopted under this chapter. An agency may receive a waiver from complying with this requirement if the waiver is approved by the director. Waivers expire at the end of the fiscal biennium for which they are granted. The director shall forward notice of waivers granted to the appropriate legislative fiscal committees. The director of financial management may require such financial, statistical, and other reports as the director deems necessary from all agencies covering any period.

(2) Except as provided in chapter 43.88C RCW, the director of financial management is responsible for quarterly reporting of primary operating budget drivers such as applicable workloads, caseload estimates, and appropriate unit cost data. These reports shall be transmitted to the legislative fiscal committees or by electronic means to the legislative evaluation and accountability program committee. Quarterly reports shall include actual monthly data and the variance between actual and estimated data to date. The reports shall also include estimates of these items for the remainder of the budget period.

(3) The director of financial management shall report at least annually to the appropriate legislative committees regarding the status of all appropriated capital projects, including transportation projects, showing significant cost overruns or underruns. If funds are shifted from one project to another, the office of financial management shall also reflect this in the annual variance report. Once a project is complete, the report shall provide a final summary showing estimated start and completion dates of each project phase compared to actual dates, estimated costs of each project phase compared to actual costs, and whether or not there are any outstanding liabilities or unsettled claims at the time of completion.

(4) In addition, the director of financial management, as agent of the governor, shall:

(a) Develop and maintain a system of internal controls and internal audits comprising methods and procedures to be adopted by each agency that will safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies for accounting and financial controls. The system developed by the director shall include criteria for determining the scope and comprehensiveness of internal controls required by classes of agencies, depending on the level of resources at risk.

(i) For those agencies that the director determines internal audit is required, the agency head or authorized designee shall be assigned the responsibility and authority for establishing and maintaining internal audits following professional audit standards including generally accepted government auditing standards or standards adopted by the institute of internal auditors, or both.

(ii) For those agencies that the director determines internal audit is not required, the agency head or authorized designee may establish and maintain internal audits following professional audit standards including generally accepted government auditing standards or standards adopted by the institute of internal auditors, or both, but at a minimum must comply with policies as established by the director to assess the effectiveness of the agency's systems of internal controls and risk management processes;

State Administrative Accounting Manual (SAAM) 20.25.30a states in part:

Commonly used control activities: The following are descriptions of some commonly used control activities. This is not an exhaustive listing of the alternatives available to management.

Review and approval – Control activities in this category are designed to provide reasonable assurance that transactions have been reviewed for accuracy and completeness by appropriate personnel.

Education, training and coaching – Control activities in this category reduce the risk of error and inefficiency in operations by ensuring that personnel have the proper education and training to perform their duties effectively. Education and training programs should be periodically reviewed and updated to conform to any changes in the agency environment or fiscal processing procedures.

SAAM 20.25.30.b

Although control activity procedures are not intended to increase staffing levels, acceptable procedures are to be established and followed which may require changes in existing workloads and/or additional staff position(s). However, a periodic thorough internal review of control activities may identify policies and procedures that are no longer required. It is recognized that some small to medium size operations may not be able to institute internal control procedures on the same level as larger, more complex agencies. In those cases where staffing may prohibit or restrict the appropriate segregation of duties, management must either have more active oversight of operations or utilize personnel from other units to the extent possible as compensating controls.

Department of Natural Resources, PR08-03-007 Monitoring Grower Accounts for Orchard/Vineyard Leases

Policy details not attached for purposes of brevity.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

Department of Natural Resources July 1, 2014 through June 30, 2015

This schedule presents the status of findings reported in prior audit periods. The status listed below is the representation of the Department of Natural Resources. The State Auditor's Office has reviewed the status as presented by the Agency.

Audit Period: July 1, 2013 to June 30, 2014	Report Ref. No: 1015212	Finding Ref. No: 2014-001
Finding Caption: The Department of Natural Resources did not follow established policy when it executed an emergency wildfire suppression contract that cost \$1.8 million.		
Background: The Department has established an internal policy that requires a written agreement be established with private contractors when assistance is needed with fire suppression activities.		
Status of Corrective Action: <input checked="checked" type="checkbox"/> Fully Corrected <input type="checkbox"/> Partially Corrected <input type="checkbox"/> Not Corrected <input type="checkbox"/> Finding is considered no longer valid		
Corrective Action Taken: <i>The Department's internal auditor is conducting an audit of emergency rentals, leases, and purchase contracts entered into by the Department for firefighting resources during the 2015 wildfire season. The internal auditor will test these items to ensure compliance with state laws and regulations and the Department's policies and procedures.</i>		

RELATED REPORTS

Financial

We perform an annual audit of the statewide basic financial statements, as required by state law (RCW 43.09.310). Our opinion on these financial statements is included in the Comprehensive Annual Financial Report (CAFR) prepared by and available from the Office of Financial Management.

The CAFR reflects the financial activities of all funds, organizations, institutions, agencies, departments and offices that are part of the state's reporting entity. That report is issued by the Office of Financial Management in December of each year and can be found at www.ofm.wa.gov.

A summary of the audit for the period ending June 30, 2015, can be found at: <http://www.sao.wa.gov/resources/Pages/AnnualReports.aspx>

Federal programs

In accordance with the Single Audit Act, we annually audit major federal programs administered by the state of Washington. Rather than perform a single audit of each agency, we audit the state as a whole. The results of that audit are published in a report issued by the Office of Financial Management in March of each year.

Special investigations

We noted certain matters that we communicated to Department management in a letter relating to the time and attendance of an employee. We appreciate the Department's commitment to resolving that matter.

INFORMATION ABOUT THE DEPARTMENT

Created in 1957, the role of the Washington State Department of Natural Resources is to protect and manage more than 5.6 million acres of forest, range, agricultural, aquatic, and commercial lands for Washington citizens. Nearly three million acres are state trust lands, most of which were given to Washington at statehood by the federal government. State trust lands managed by the Department to help support counties, public schools, universities and colleges, capitol buildings, prisons and state institutions, local services in many counties, and the state General Fund. Department-managed lands also provide many other public benefits, such as destinations for outdoor recreation, fish and wildlife habitat, and clean air and water.

The Department also protects natural resources through fire prevention and suppression and regulating forest practices. For the audit period, the Department employed approximately 1,252 permanent employees. Elected Commissioner of Public Lands, Peter Goldmark heads the Department. For the 2013-2015 biennium, the Department had operating budgets of approximately \$418 million.

Contact information related to this report	
Address:	Department of Natural Resources P.O. Box 47041 Olympia, WA 98504-7041
Contact:	Charles Malone, Risk Manager
Telephone:	(360) 902-1264
Website:	www.dnr.wa.gov

Information current as of report publish date.

Audit history

You can find current and past audit reports for the Department of Natural Resources at <http://portal.sao.wa.gov/ReportSearch>.

ABOUT THE STATE AUDITOR'S OFFICE

The State Auditor's Office is established in the state's Constitution and is part of the executive branch of state government. The State Auditor is elected by the citizens of Washington and serves four-year terms.

We work with our audit clients and citizens to achieve our vision of government that works for citizens, by helping governments work better, cost less, deliver higher value, and earn greater public trust.

In fulfilling our mission to hold state and local governments accountable for the use of public resources, we also hold ourselves accountable by continually improving our audit quality and operational efficiency and developing highly engaged and committed employees.

As an elected agency, the State Auditor's Office has the independence necessary to objectively perform audits and investigations. Our audits are designed to comply with professional standards as well as to satisfy the requirements of federal, state, and local laws.

Our audits look at financial information and compliance with state, federal and local laws on the part of all local governments, including schools, and all state agencies, including institutions of higher education. In addition, we conduct performance audits of state agencies and local governments as well as [fraud](#), state [whistleblower](#) and [citizen hotline](#) investigations.

The results of our work are widely distributed through a variety of reports, which are available on our [website](#) and through our free, electronic [subscription](#) service.

We take our role as partners in accountability seriously, and provide training and technical assistance to governments, and have an extensive quality assurance program.

Contact information for the State Auditor's Office	
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