



STATE OF NORTH CAROLINA

SPECIAL REVIEW

NORTH CAROLINA MUSEUM OF ART

RALEIGH, NORTH CAROLINA

JANUARY 2006

OFFICE OF THE STATE AUDITOR

LESLIE W. MERRITT, JR., CPA, CFP

STATE AUDITOR

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State Auditor

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AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
Ms. Lisbeth C. Evans, Secretary, Department of Cultural Resources

Pursuant to North Carolina General Statute §147-64.6(c)(16), we have completed our special review of allegations concerning the North Carolina Museum of Art. The results of our review, along with recommendations for corrective action, are contained in this report.

Copies of this report have been provided to the Governor, the Attorney General and other appropriate officials in accordance with North Carolina General Statute §147-64.6(c)(12) which requires the State Auditor to provide written notice of apparent instances of violations of penal statutes or apparent instances of malfeasance, misfeasance, or nonfeasance by an officer or employee.

Leslie W. Merritt, Jr., CPA, CFP
State Auditor

January 24, 2006

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INTRODUCTION

We received a complaint through the State Auditor's Hotline alleging employees of the North Carolina Museum of Art (the Museum) received bonuses in the form of salary supplements. Allegedly, the North Carolina Museum of Art Foundation, Inc. (the Foundation) provided the funding for these supplements.

The Foundation is a private non-profit organization established by the laws of the State of North Carolina, as contained in Chapter 55-A of the General Statutes. The Foundation was established in 1969 to "foster and promote the growth, progress and general welfare of the North Carolina Museum of Art, at Raleigh, North Carolina, by whatever name it is designated, and to receive and administer gifts and donations for such purposes."

We used the following procedures to conduct a special review of these allegations:

- Interviews with management at the North Carolina Department of Cultural Resources, the Museum and the Foundation;
- Interviews with individuals external to the Museum including the Office of State Personnel, the State Treasurer's Office, and the Attorney General's Office;
- Review of North Carolina General Statutes as they relate to the Museum, the Foundation, the North Carolina Art Society, the North Carolina Museum of Art Board of Trustees, and Museum employees;
- Review of documents related to the operations of the Museum related to personnel and financial matters.
- Review of audited financial statements for the Foundation.

This report presents the results of our special review. The review was conducted pursuant to North Carolina General Statute § 147-64.6(c)(16) rather than a financial audit. As a division of the Department of Cultural Resources, the Museum is subject to financial audit procedures within the Office of the State Auditor's audit of the State's Comprehensive Annual Financial Report. An independent public accounting firm conducts an annual audit of the Foundation.

FINDINGS AND RECOMMENDATIONS

1. THE NORTH CAROLINA MUSEUM OF ART IS IN VIOLATION OF THE STATE PERSONNEL ACT (CHAPTER 126 OF THE NORTH CAROLINA GENERAL STATUTES) AS A RESULT OF STATE EMPLOYEES RECEIVING SALARY SUPPLEMENTS.

Information provided by the Department of Cultural Resources (the Department), the Museum and the Foundation indicates that at least 58 state employees have received salary supplements. The information indicates that the supplements were paid to at least nine employees dating as far back as 1998.

In 1998 the Foundation paid a total of \$60,145 in supplements to nine state employees. In 2004, the Foundation paid 33 of the 79 state employees a total of \$372,999 in supplements. This sum does not include the total supplemental amounts paid to the Director and the Assistant Director of Marketing. (See Findings 2 & 4). The supplements were paid directly to the employees. The additional pay was not reflected in their base salary and was not used to determine retirement contributions and receipts.

The employees were not required to perform duties outside their normal job responsibilities to receive these supplements. We recognize that these circumstances may not reflect the exact definition of dual employment. However, due to the relationship between the Foundation and the Museum (See Finding 7), in our opinion these supplements violate the Office of State Personnel dual-employment policy that states “no employee, even while on paid leave, may be paid additionally for services performed for the employee’s parent agency.”

Management of the Department and the Foundation reviewed the job duties for those positions that were receiving supplements. Their review indicated that the employees had no additional duties and were not performing additional work to justify the additional pay.

The State Personnel Act does not allow salaries to be paid above the maximum range established for a specific salary grade as established by the State Personnel Commission. The payment of supplements resulted in nine SPA (subject to the personnel act) employees exceeding the maximum salary allowed for their salary grade as established by the Office of State Personnel.

The State Personnel Act also addresses in-range salary adjustments during a year’s period. The Act states “the maximum in-range adjustments shall be consistent with the employee’s related training and experience and shall not exceed 10 % within a one-year period, not to exceed the maximum of the current salary grade, and not create significant salary inequities.”

The supplements paid to 16 of the 23 SPA state employees were greater than 10% of the base salary. The supplements were all greater than 10 % of the base salary for the seven EPA (exempt from the personnel act) state employees. Thus, in our opinion, the Foundation’s payment of supplements to state employees violates these provisions of the State Personnel Act.

FINDINGS AND RECOMMENDATIONS (CONTINUED)

Our review of available records did not indicate any prior approval from State Personnel, the Department or the State Budget Office prior to the payment of supplements. The only Department documentation located in reference to the supplements was an August 31, 2004, memo from the Secretary of Cultural Resources to the Director. This memo was to serve as confirmation that effective immediately, there were to be no new supplements given or any increases in any supplement to any state employee without advanced review and approval by the Secretary's office.

A review of the documentation did not indicate that the practice of paying state employees supplements from the Foundation existed prior to the employment of the Director in 1994. When asked about the practice of paying state employees a supplement, the current Director indicated that he felt a precedent had been established for such a practice when the Foundation first agreed to supplement his salary. He indicated that he would not have accepted his current position based on the salary as set by Statute. When he was hired, they were just continuing the practice of letting the Foundation supplement the salary to attract a better candidate for the position.

The Director and the Foundation had the same sentiment about hiring and retaining museum staff. They believed the current pay limits were not adequate to hire and retain the best staff for the Museum.

Since all state employees of the Museum did not receive a supplement, we asked the Director how he decided who received the supplement and how much they received. He indicated that the process was initiated by the employees. If an employee came to him and stated that they did not feel like they were getting paid at the market rate and may consider employment elsewhere, he would consult the Association of Art Museum Directors annual salary survey.

The annual survey gives a description of each position within the museum and it includes a salary matrix which is based on the size of museum, the budget of the museum and the population of the area where the museum is located. The salary of the employee was compared to those of similar museums, and if it was in the lower portion of the matrix, the Director would request a supplement for that employee from the Foundation. The information was not sent to Department management or State Personnel prior to implementing the supplement.

With regards to the supplements, the Director indicated that he may have gone around State policy, but that he was doing what was best for the Museum. The Director indicated when he took over, the Museum was in the midst of a period of growth and it was important for him to use all of his resources to expand the staff and keep qualified staff.

The Director indicated he went to State Personnel on several occasions to get many of the positions at the Museum upgraded to be more in line with the same positions within other agencies, but time and time again, he was denied any change. He indicated that on one occasion, State Personnel did agree to upgrade one set of positions, but the General Assembly did not include the additional funds necessary to fund the upgrades, so the

FINDINGS AND RECOMMENDATIONS (CONTINUED)

employees did not receive an increase. He indicated he thought by offering a supplement equal to what the employee may get in an upgrade, he may jumpstart the process and get the General Assembly to agree and include the funding in the next budget. The additional funding never came, and the supplements continued.

Upon learning of our inquiry concerning the pay supplements, senior management at Cultural Resources continued their review of this issue. Department management realized that changes should be made in order to comply with the policies as established by statute and State Personnel. Department management, working in conjunction with State Personnel, reviewed the job descriptions and responsibilities for those state employees that were receiving salary supplements.

They found that many of the employees were in positions that could be reclassified to more accurately reflect their duties within the museum. Most of the employees receiving supplements were reclassified into the position of associate director or curator. As indicated in the statutes, these positions are exempt from the provisions of the State Personnel Act.

The positions were reclassified as of November 1, 2005. Once reclassified, the employees serving in these roles are to be governed by the Board of Trustees of the Museum. The statutes require that “the Board of Trustees shall adopt, subject to approval of the Secretary of Cultural Resources, rules and regulations governing the employment, promotion, demotion, and dismissal of associate directors and curators.” Prior to the reclassification of the positions, the Deputy Secretary for Cultural Resources helped the Board of Trustees establish the rules and regulations regarding the associate directors and curators.

The 2005-06 Museum budget includes 26 state employees that were scheduled to get a salary supplement from the Foundation. As a result of the reclassification process completed with input from State Personnel, 12 of the 26 employees were placed in positions that are statutorily exempt from the State Personnel Act. Including the Director and the Assistant Director of Marketing, the Museum currently has 14 state employees that are still receiving supplements.

One position that was receiving a supplement was transferred to the Museum of History, and is no longer receiving a supplement. The other 11 positions that were previously receiving a supplement had their positions reviewed by State Personnel and they were either given an in-range adjustment or an inequity adjustment pay increase. These positions will no longer receive supplements. In most cases, the pay increase was equal to the supplement that was discontinued.

It is the contention of the Department that state employees that are in EPA positions, are still eligible to receive salary supplements because they are statutorily exempt from the provisions of the State Personnel Act. However, the Board of Trustees that has the responsibility to set personnel guidelines for these positions does not have policies and procedures in place to govern this practice.

FINDINGS AND RECOMMENDATIONS (CONTINUED)

RECOMMENDATION

The Department of Cultural Resources and the Museum should suspend the practice of allowing state employees to receive salary supplements from the Foundation. While the Department has worked with staff members at the Museum to reclassify all SPA positions to better reflect the duties and pay rates for those positions, there are still 14 state employees receiving salary supplements. The Department should request assistance from State Personnel and the Attorney General to determine the legality of supplementing EPA positions with additional compensation from the Foundation. If that practice is found to be permissible, senior management in the Department should work closely with the Board of Trustees to develop a more detailed set of policies and procedures dealing with the payment of supplements. These policies and procedures should identify the personnel responsible for determining eligibility and supplemental compensation.

2. THE TOTAL COMPENSATION PAID TO THE DIRECTOR OF THE MUSEUM OF ART EXCEEDS THE COMPENSATION SET FORTH IN LEGISLATION.

The salary of the Director is fixed by the General Assembly in the Current Operations Appropriations Act per G.S.140-5.15(c). House Bill 1414, as set forth in Session Law 2004-124, (Part XXXI, Section 30.3), states “the annual salary for the 2004-05 fiscal year for the Museum of Art Director is \$97,621.” The total compensation paid to the Director for the 2004-05 fiscal year was approximately \$358,041. Thus, the Director’s total compensation exceeds the annual salary established by statute.

The salary compensation package includes the items listed in the table below:

TOTAL COMPENSATION PAID TO THE DIRECTOR OF THE NORTH CAROLINA MUSEUM OF ART IN 2004-05	
State salary	\$97,621
Foundation salary supplement	111,192
Foundation consulting fee	130,000
Additional Foundation consulting fee	5,642
Vehicle lease payments	11,293
Vehicle fuel costs	1,043
Vehicle insurance	1,250
Total	\$358,041
Source: N.C. Museum of Art and the N.C. Museum of Art Foundation	

FINDINGS AND RECOMMENDATIONS (CONTINUED)

Proponents for the Museum, including the Foundation, insist that the wage set by legislation is not appropriate and will not allow the Museum to continue to employ a qualified director. In order to ensure that the Museum can attract and keep the most qualified director, the Foundation supplements the salary of the director. Based on records obtained through the Museum, the annual salary of the Director has been supplemented by the Foundation since May 1981. While there is little to no documentation detailing the origins of the supplements, documentation does provide insight into the supplement paid to the current Director.

The current Director was hired on August 31, 1994, with a negotiated annual salary of \$116,000.00. The State portion of that salary, as set by General Statutes, was \$79,274 and the remaining \$36,726 was supplemented by the Foundation. The original supplement equated to 46.3% of the State salary. Over the years the amount of the Foundation supplement has increased.

The Director currently receives a supplement from the Foundation in the amount of \$111,192 per year. As a result, the Director receives a yearly supplement from the Foundation equivalent to 113.9% of his \$97,621 state salary. The Director receives 53% of his total salary from the Foundation.

In addition to the salary supplement, the Foundation provides an automobile for the Director and pays for the vehicle's fuel and insurance. The Director is also given an expense account and credit card. The Director uses the credit card for purchases of airfare, lodging, rental cars, meals and entertainment.

The charged amounts are compared against the travel expense reports submitted each month by the Director and paid for by the Foundation. If the Director purchases anything with cash, he simply includes the related receipts with his monthly travel expense report and he receives reimbursement for those costs. From July 2004 through June 30, 2005, the Director's travel and entertainment expenses totaled \$57,140.

The Director indicated that while his current compensation package is in line with those of his counterparts at other museums, it would probably be on the low side of the total compensation packages of his counterparts. This information is based on the annual salary report prepared by the Association of Art Museum Directors. This report is comprised of surveys sent out to museums across the U.S.

The 2004 report was based on an 80% response rate from 238 museums. It also notes approximately 74% of the responding museums were private, non-profit entities. In our opinion, establishing compensation for a government museum Director based on information derived mainly from private museums is unrealistic.

FINDINGS AND RECOMMENDATIONS (CONTINUED)

RECOMMENDATION

The Department of Cultural Resources should fully disclose the financial relationship between the Director, the Foundation and the Department to members of the General Assembly and the public.

The General Assembly should be apprised of the total compensation package for the Director, on an annual basis. As stated in N. C. G. S. § 140-5.15 (c), "The salary of the Director shall be fixed by the General Assembly in the Current Operations Appropriations Act." The General Assembly should review all available information to ensure the total compensation for the Director is accurately reflected in the state budget.

The Department of Cultural Resources and the Foundation should clearly define the role of each organization and its relationship with the Director in terms of a reporting structure. The Secretary of Cultural Resources should request assistance from OSP to determine adequate compensation for the Director using best practices and based on information obtained from government museums that mirror the Museum of Art.

3. THE DIRECTOR OF THE MUSEUM ENTERED INTO A CONSULTING AGREEMENT WITH THE FOUNDATION WITHOUT OBTAINING WRITTEN APPROVAL FROM THE SECRETARY OF THE DEPARTMENT OF CULTURAL RESOURCES.

On May 1, 2005, the Director entered into a five-year consulting contract with the Foundation. The terms of the contract indicate it will automatically be renewed for one year annually on or about April 30, unless one of the parties submits 30 days notice prior to April 30th to terminate it. The contract includes an initial payment of \$130,000 and an annual consultant fee equal to 4% of his total salary for the corresponding year.

The Department interpreted the consulting contract to include the following additional duties for the Director:

- 1) To cultivate and solicit collectors outside of North Carolina;
- 2) To negotiate the Cantor Foundation gift to the N.C. Museum of Art;
- 3) To cultivate and solicit capital donors outside of North Carolina;
- 4) To direct the new museum building project to highest international standards.

Museum policy requires prior management approval for secondary employment. Specifically, the policy states, "In the case of state employees, the Director and the Secretary of Cultural Resources must give prior consent in writing in accordance with State personnel policy." The Museum's Ethics Policy also states, "Outside employment for compensation shall not be undertaken while on Museum time or traveling at Museum expense unless previous arrangements have been made to donate such compensation to the Museum and prior approval has been granted by the Director or Associate Director."

FINDINGS AND RECOMMENDATIONS (CONTINUED)

A review of the Director's personnel file did not indicate that a secondary employment form had been completed indicating written approval from the Secretary of the Department of Cultural Resources. While the personnel file located at the Department did not contain an approved secondary employment form, Department management said they had given verbal approval. Department management and the Director both confirmed that a secondary employment form was not completed.

During an interview with the Director, he indicated that the duties associated with the consultant contract were the same duties he is responsible for as the Director. The Director does not see the consulting contract as a contract for secondary employment. It is his view that any benefit derived from the consulting contract is merely additional compensation for performing his duties as the Director.

RECOMMENDATION

The Department should resolve the contradiction between whether this situation is interpreted as secondary employment or additional compensation for performing the Director's primary duties. If the contract represents secondary employment, then the Director should follow Department policy and should obtain prior written approval before entering into a contract for secondary employment. The Director should also request written approval from the Board of Trustees of the Museum, since it is their responsibility to adopt policies, rules, and regulations for the conduct of the Museum.

4. THE DEPARTMENT OF CULTURAL RESOURCES ALLOWED FOUNDATION COMPENSATION SUPPLEMENTS TO BE PROCESSED THROUGH THE STATE RETIREMENT SYSTEM.

Each month the Department bills the Foundation for the costs of the salary supplement for the Director and the Assistant Director of Marketing, plus the Social Security tax and retirement contribution associated with the supplement. When the Department receives the funds they are placed in the appropriate compensation account. All compensation funds for Department employees are then forwarded to the State Treasurer's Office for processing.

The Foundation paid the salary supplements directly to the two previous Museum Directors. Prior to hiring the current Director, the Secretary of the Department of Cultural Resources discussed the possibility of making a change in the process. It was the desire of the Secretary to underscore the Director's responsibility to the Department and state government. On August 24, 1994, the Secretary approached the President of the Foundation to inquire as to the possibility of the Foundation agreeing to supplement the Director's salary in the amount of \$36,726 plus 10.96% to cover the retirement costs that would have to be paid on behalf of the Director. The President responded to the Secretary on August 31, 1994, with the Foundation's approval of that action.

FINDINGS AND RECOMMENDATIONS (CONTINUED)

On September 12, 1994, a budget transfer request was submitted to the Office of State Budget and Management by the Department to authorize a transfer of funds increase. The request was approved by the State Budget analyst for the Department on October 17, 1994. The approval only authorized an increase in a budgeted salary line item. The justification for the request stated that the Foundation would be billed for the difference between the agreed-upon hiring salary and the salary set forth in legislation. Because the funds would be treated as regular compensation from the Department, the Foundation also agreed to provide the funds to cover the fringe benefits (retirement, Social Security, and taxes) that are normally associated with a state-funded position.

As a result, the Foundation pays the supplement directly to the Department so the Director only receives one paycheck from the State's Central Payroll. This supplement is paid monthly by the Foundation through the N. C. Department of Cultural Resources and is reflected in the State Employees Retirement System.

This process began for the current Director when he was hired in 1994. Prior to 1994, any supplement paid by the Foundation was paid directly to the employee in the form of a check that was sent to the employee's residence. The former Secretary of Cultural Resources believed it was necessary for the Director to receive one paycheck from the State to maintain his allegiance to the State and not to the Foundation.

While the Department of Cultural Resources did submit the proper paperwork to have the transfer of funds approved, they did not seek approval from State Personnel, the State Treasurer's Office, or the General Assembly. Management at State Personnel and the State Treasurer's Office indicated that there was no documentation indicating the Department received approval to pay the Director above his salary as set by legislation from either agency. In our opinion, the Department should have obtained approval from both State Personnel and the State Treasurer's Office for this arrangement.

The Assistant Director's supplement is paid in the same manner as the Director. He receives a state salary of \$72,402 and a supplement of \$23,392 from the Foundation. The total supplement amount plus the cost of benefits is paid by the Foundation to the Department of Cultural Resources. It is then processed through state payroll so that he may receive retirement benefits for his total State and Foundation combined compensation. No statutory authority exists allowing such action.

We asked the Director if there was any particular reason why the supplement for the Assistant Director of Marketing was also processed through the State Retirement System. He indicated that there was not a special reason. The Director said the Assistant Director in charge of Finance at the time processed it that way to make it easier.

Officials with the Office of the State Treasurer indicated they were not aware that Foundation supplements were processed through the retirement system. They receive the supplement amounts with the collection of funds from other state employees. There is no way to differentiate where the funds are coming from because they are all submitted under

FINDINGS AND RECOMMENDATIONS (CONTINUED)

one account. The other state employees that receive supplements are not getting the retirement benefits associated with the increase in pay they are receiving which creates another inequity.

RECOMMENDATION

The Department of Cultural Resources should request assistance from the Office of State Personnel and from the Attorney General's office to determine legally, if additional compensation paid by a non-profit entity can flow through the state employee retirement system.

If the practice is determined to be allowable, management within the Department of Cultural Resources should work with the Museum Board of Trustees to establish policies and procedures to govern the process. The policies should address all museum employees, compensation adjustments, and additional sources of compensation.

5. THE NORTH CAROLINA MUSEUM OF ART FOUNDATION MAY HAVE VIOLATED FEDERAL TAX REGULATIONS BY EXECUTING EMPLOYMENT CONTRACTS WITH STATE EMPLOYEES AND REPORTING THEIR EARNINGS AS NON-EMPLOYEE COMPENSATION.

Internal Revenue Code § 3401 (d)(1) provides, "...if a common law employer does not have control over the payment of wages for services provided by its employees, the entity that does control such funds legally steps into the common law employer's shoes for tax withholding purposes." Based on that language, the Foundation would be required to: 1) withhold appropriate federal and state taxes for museum employees to whom the Foundation provides a wage supplement and 2) issue a W-2 to employees.

Prior to 2002, each employee receiving a supplement was issued a Form 1099-Misc at year end. The issuance of 1099s implied that the employees were actually independent contractors. Each employee was also asked to sign an employment contract. The contract stated that this was an agreement between the employee and the Foundation to perform services to justify the payment of the supplements. The "scope of services" listed in the contract stated: "The contractor, in connection and cooperation with the Foundation, shall within time and funds constraints stated within this Agreement, do, perform and carry out in a satisfactory and proper manner, as determined by the Foundation, the following services: Duties in connection with state employment."

Based on the wording of that document, each employee that received a supplement entered into a contract for secondary employment. In addition to the employment status and tax implications associated with this agreement it also has implications for the Department. A review of the personnel files of the individuals receiving the supplements indicated that prior approval per Department policy was not obtained.

FINDINGS AND RECOMMENDATIONS (CONTINUED)

On advice of legal counsel and input from an independent public accounting firm, the Foundation made a decision to stop the practice of entering into a contract with each employee. Because of the tax implications, the Foundation decided to go forward with reporting the supplements in a different manner. Each employee now receives a Form W-2 at year end that reflects these supplements except the Assistant Director for Marketing and the Director (See Finding 4).

RECOMMENDATION

The Department and the Foundation should request legal assistance to determine if Federal tax regulations were violated and resolve any associated legal issues.

6. THE NORTH CAROLINA ART SOCIETY TRANSFERRED ITS LEGISLATIVE RESPONSIBILITIES TO THE NORTH CAROLINA ART MUSEUM FOUNDATION WITHOUT PROPER LEGISLATIVE ACTION.

In 1961, the North Carolina Art Society, Inc. was established by the Legislature as noted in G.S. § 140-14. The statute states, “The North Carolina Art Society, Incorporated, shall be the membership arm of the North Carolina Museum of Art, the means whereby citizens of North Carolina can support their museum through individual or corporate memberships in the Society and through participation in its diverse programs. It shall be the duty of the North Carolina Art Society to promote the public appreciation of art and its role in the development of civilization; to organize State and regional art exhibits, including works by contemporary North Carolina artists; and to do all other things deemed necessary to advance the objectives of the Society.”

A review of the Museum Board of Trustees meeting minutes indicated that the Art Society delegated its membership duties to the Foundation without changing legislation to allow such a transfer of duties. The Art Society is still involved with promoting and supporting the Museum, but is no longer fulfilling its duty as prescribed in the statute.

RECOMMENDATION

The Department should work in conjunction with the North Carolina Art Society to request a change in legislation that accurately reflects the duties of the Art Society and the Foundation as it relates to the management of the membership function for the Museum.

7. THE NORTH CAROLINA MUSEUM OF ART FOUNDATION’S MANAGEMENT OF THE NORTH CAROLINA MUSEUM OF ART INCLUDES SUPERVISION OF STATE EMPLOYEES AND OTHER SIGNIFICANT FINANCIAL AND OPERATIONAL CONTROL.

The Foundation was established in December of 1969. The Foundation is a private non-profit organization established by the laws of the State of North Carolina, as contained in Chapter 55-A of the General Statutes. According to the Articles of Incorporation, the purpose of the Foundation was “to foster and promote the growth, progress and general welfare of the North Carolina Museum of Art, at Raleigh, North Carolina, by whatever

FINDINGS AND RECOMMENDATIONS (CONTINUED)

name it is designated, and to receive and administer gifts and donations for such purposes.”

Over the years the Foundation has grown and it now consists of 73 employees and is governed by a 27-member Board. As the size of the Foundation has grown, so has its financial support. The most recent information indicates that the Foundation underwrote approximately \$7 million of the operating expenses for the Museum. This amount includes the supplements that are paid to the state employees, plus other operational expenses.

The Museum is a division of the Department of Cultural Resources. According to state budget records, the Department receives approximately \$4.5 million dollars from the State budget each year to operate the museum. This money is to be used to pay for operational costs at the museum and to fund 78 full-time positions at the museum.

The amount provided by the state appropriation does not adequately cover all the operational costs of the Museum. A review of recent expenditures at the Museum, indicate that the actual total operational budget is approximately \$11 million dollars per year. These costs include travel, advertising, supplies, furniture, freight, and other operational expenses. Without additional funding from outside sources, the Museum would not be able to continue to operate based on current spending.

Another result of the expanded Museum budget is the addition of a Deputy Director/Chief Operating Officer (COO), and a Chief Financial Officer (CFO). Both of these employees have significant roles in the operations of the museum, and both are employees of the Foundation. The COO is in charge of the daily administrative operations of the museum in the absence of the Director while the CFO is responsible for the daily financial operations.

The CFO’s responsibilities include managing both the Foundation’s funds and the funds appropriated to the Department for the Museum in the State’s budget. The CFO has the responsibility of determining what expenses are paid for by the Foundation and what expenses are paid for by the Department. The state appropriated funds are restricted in the types of expenses they cover, but the decision about which organization pays certain expenses is made by the CFO of the Foundation.

Other examples of the integration of the Foundation into the operational management of the Museum include:

- * The Director, who is a state employee, said he is essentially the Chief Executive Officer of the Foundation and receives more in compensation from the Foundation than from the State;
- * The Foundation Chief Operating Officer is responsible for the administrative operations of a the Museum even though the COO is a Foundation position;

FINDINGS AND RECOMMENDATIONS (CONCLUDED)

- * Foundation funds are used to reimburse the costs of travel for state employees, at rates that violate State Motor Fleet Policy;
- * Foundation employees are supervised by state employees;
- * State employees are supervised by Foundation employees.

The Museum is a State museum that receives funding assistance from a private foundation, yet it operates in many ways as a private museum that receives state funding. In our opinion, the operations of the Foundation and the Museum are so integrated, that a hybrid organization now exists.

Outside sources, including the public, also have difficulty distinguishing between the two entities. The Foundation occupies office space within the Museum and has email addresses and phone numbers within the State system. Anyone interested in membership information or making a donation to the museum, does so through the Foundation, but at the address of the Museum. Even the Foundation Board meetings minutes are maintained on Museum letterhead.

In the most recent independent financial audit of the Foundation, the CPA firm reported that certain state expenditures for the Museum constituted a grant to the Foundation for financial reporting. The rationale behind this interpretation was based on the CPA firm's receipt of a confirmation from the Department that noted expenses were paid by the Department on behalf of the Foundation. These expenditures were actually operating expenses of the Museum, not the Foundation.

RECOMMENDATION

The Museum is in fact a State museum and should be operated as such. While the contributions of the Foundation are very much needed and appreciated, the Foundation has extensive control over the daily operations of the Museum. The Department should work in conjunction with the General Assembly, the Office of State Personnel and the Attorney General's Office to review the operational aspects of the Museum to ensure that the Museum is operated as a state entity. These agencies should evaluate the involvement of the Foundation with the Museum and those relationships should be established in writing. The Department may also want to consult with other state-owned museums to determine if they have suggestions or practices in place that work best given similar situations. The Museum is at a crucial stage in its existence as it looks forward to possible expansion. The Department should ensure that the operational structure of the Museum allows it to operate within state rules and regulations for the citizens of North Carolina.

STATE AUDITOR'S NOTE

The Office of the State Auditor has carefully reviewed the response to this report from the Department of Cultural Resources (the Department). Notwithstanding the Secretary's arguments and assertions, the facts and circumstances presented in this report accurately reflect the results of our investigation. While we acknowledge the Department has initiated significant corrective action since we began our investigation, the response merits the following comments.

FINDING 1:

Notwithstanding the response of the Secretary, the report accurately applies the relevant law to the facts as uncovered in our investigation. It is important to note that the practice of paying supplements to Museum employees raises policy and equity issues in that other similarly situated state employees do not have the opportunity or access to supplemental pay.

FINDING 2:

Notwithstanding the response of the Secretary, the report accurately applies the relevant law to the facts as uncovered in our investigation.

FINDING 3:

Notwithstanding the response of the Secretary, the report accurately applies the relevant law to the facts as uncovered in our investigation. The Secretary correctly indicates that a secondary employment form was placed in the Director's personnel file on November 30, 2005, referring to a contract that became effective on May 1, 2005.

FINDING 4:

In 1994, the Museum began the questionable practice of processing the Director's supplemental pay through the State Retirement System, thereby significantly increasing the Director's future state retirement benefits. Eleven years later, the Department sought assistance concerning the legality of this practice from the Office of State Personnel and the North Carolina Attorney General. The more prudent course is to seek guidance concerning legality prior to engaging in a questionable practice.

FINDING 5:

After careful consideration, this finding was included because of the interdependent nature of the Museum and the Foundation and the tax implications for state employees.

FINDING 6:

No comment necessary.

FINDING 7:

We note that the Secretary neither disputes the interdependent relationship of the Museum and the Foundation, nor the fact that state employees at the Museum are directly supervised and under the control of non-state employees.

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RESPONSE FROM DEPARTMENT OF CULTURAL RESOURCES



North Carolina Department of Cultural Resources Office of the Secretary

Michael F. Easley, Governor

Lisbeth C. Evans, Secretary

January 19, 2006

Mr. Leslie W. Merritt, Jr., State Auditor
North Carolina Office of the State Auditor
Raleigh, North Carolina

Corrected Copy

Dear Mr. Merritt:

The Department of Cultural Resources (the "Department") has received in confidential draft form, the Special Review Report (the "Report") on the North Carolina Museum of Art (the "Museum"). We appreciate the opportunity to respond to the report. After careful and thoughtful review of the Findings and Recommendations, we offer the following response:

1. THE NORTH CAROLINA MUSEUM OF ART IS IN VIOLATION OF THE STATE PERSONNEL ACT (CHAPTER 126 OF THE NORTH CAROLINA GENERAL STATUTES) AS A RESULT OF STATE EMPLOYEES RECEIVING SALARY SUPPLEMENTS.

The Department has worked diligently over a two year period to address and resolve salary supplement issues at the Museum. A distinction must be made with regard to those employees who are subject to the provisions of the State Personnel Act and with those who are statutorily exempt from the Act. No State employee who is subject to the State Personnel Act is receiving a supplement from the Foundation. The Director of the Office of State Personnel has approved the practice of salary supplement made by the Foundation to exempt employees. Therefore, we have resolved the salary supplement issues that exist and are in compliance with all applicable law. The Department will work closely with the Board of Trustees to establish policies addressing supplements to exempt employees.

However, the Finding that the Museum is in violation of the State Personnel Act as a result of State employees receiving a salary supplement is contrary to existing law. The State Personnel Act does not prohibit salaries to be paid above the maximum range. In fact, administrative rules promulgated pursuant to G.S. § Chapter 126 support this position:

25 NCAC 01D .0102 SALARY RANGES

. . . (b) Based on labor market demands, salary rates for some classifications may be approved above the standard rates. When a higher salary range (i.e., both

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the minimums and maximums are raised) is needed to recruit employees to certain areas of the state, the higher range(s) will be known as geographic differentials. . . .

The Findings further conclude that the supplements given by the Foundation violate the in-range salary adjustment rules and policies of the State. In fact, the supplements do not meet the definition of an "in range salary adjustment" as defined in 25 NCAC 01D .2601

2. THE TOTAL COMPENSATION PAID TO THE DIRECTOR EXCEEDS THE COMPENSATION SET FORTH IN LEGISLATION.

G.S. § 5.15(c) provides that the salary of the Director shall be fixed by the General Assembly in the Current Operations Appropriations Act. G.S. § 143-15.1, provides that "[t]he Current Operations Appropriations Act shall state the amount of General Fund appropriations availability upon which the General Fund budget is based. (emphasis added) However, the Act is limited solely to appropriations from the General Fund. Although this statute sets the Director's salary derived from appropriated funds, it does not prohibit the Director from receiving additional compensation from other unappropriated sources, namely the Foundation.

The Department has been diligent in accurately reporting the Director's salary to the press, the Office of State Personnel and to the legislature while being especially careful to point out that the Foundation supplements the Director's salary in a greater amount than his statutorily appropriated salary.

3. THE DIRECTOR OF THE MUSEUM ENTERED INTO A CONSULTING AGREEMENT WITH THE FOUNDATION WITHOUT OBTAINING WRITTEN APPROVAL FROM THE SECRETARY OF THE DEPARTMENT OF CULTURAL RESOURCES.

Both the Secretary and her Chief Deputy verbally approved the consulting agreement between the Museum Director and the Foundation prior to its execution. As indicated in the Findings, the Director's personnel file did not contain written documentation at the time it was examined by a representative of the Auditor. However, a secondary employment form confirming approval was placed in the Director's personnel file on November 30, 2005.

4. THE DEPARTMENT OF CULTURAL RESOURCES ALLOWED FOUNDATION COMPENSATION SUPPLEMENTS TO BE PROCESSED THROUGH THE STATE RETIREMENT SYSTEM.

The Director's and Assistant Director's salary supplement are processed through the State Retirement System, and have been since 1994. However, the statement in the Findings that the Department "did not seek approval from the Office of State Personnel, the State Treasurer's Office, or the General Assembly" is in error. On or about April 6, 2005, the Department met with the Director of OSP, a representative from the State

Retirement System and legal counsel to discuss the legality of such a practice. At that meeting, the Department sought assistance from the Director of the Office of State Personnel through the Attorney General's Office to provide guidance in the form of an opinion. To date, the Department has not received an opinion.

5. THE NORTH CAROLINA MUSEUM OF ART FOUNDATION MAY HAVE VIOLATED FEDERAL TAX REGULATIONS BY EXECUTING EMPLOYMENT CONTRACTS WITH STATE EMPLOYEES AND REPORTING THEIR EARNINGS AS NON-EMPLOYEE COMPENSATION.

The North Carolina Museum of Art Foundation, Inc. (the Foundation) is a private non-profit organization established by applicable State and Federal Law. The Foundation is not a part of the Department of Cultural Resources. Since this Finding regards alleged noncompliance by an entity other than the Museum, it is not appropriately contained in the Report. However, because it is included in the Department's Report, we will comment on the Finding and will share this response with the Foundation's board.

The Department understands that the Foundation sought the advice of a tax attorney and independent accounting firm in order to make a determination as to how it should proceed in reporting to the Internal Revenue Service. The Department has no reason to question the advice provided by counsel to the Foundation. Moreover, the Department was not consulted regarding the "tax implications" of paying salary supplements.

6. THE NORTH CAROLINA ART SOCIETY TRANSFERRED ITS LEGISLATIVE RESPONSIBILITIES TO THE NORTH CAROLINA ART MUSEUM FOUNDATION WITHOUT PROPER LEGISLATIVE ACTION.

The language of the statute regarding the Art Society of North Carolina allows the Society to "do all things necessary to advance the objectives of the Society." Notwithstanding this, the Department accepts the Recommendation to request a change in legislation that accurately reflects the duties of the Society.

7. THE NORTH CAROLINA MUSEUM OF ART FOUNDATION'S MANAGEMENT OF THE MUSEUM OF ART INCLUDES SUPERVISION OF STATE EMPLOYEES AND OTHER SIGNIFICANT FINANCIAL AND OPERATIONAL CONTROL.

The Department appreciates the understanding of the Auditor regarding the size and operational needs of the Museum. The costs of operating a world class museum are significant and as the Auditor has noted, the amount provided by the state appropriation does not adequately cover all the operational costs of the Museum. The Auditor also noted that the Foundation has generously provided approximately 65% of the operating

costs to the Museum. We agree that this is an invaluable contribution to the State and its citizens.

In November of 2005, the Department and the Foundation drafted an operating agreement that clarifies the working relationship between the Museum and the Foundation. The operating agreement was modeled after the Art Museum of New Mexico. The Department knows of no other State museum that has an operation agreement with a private non-profit Foundation.

CONCLUSION

The Department will continue to engage the appropriate State oversight agencies to assess the current Department practices questioned in the Report. Where any noncompliance is confirmed by a State oversight agency, corrective action will be taken. For example, prior to the Auditor's review the Department was addressing the reported issue of salary supplements with the Office of State Personnel, the Office of State Budget and Management, and the Office of the Attorney General.

The North Carolina Museum of Art will have adequate internal control and will operate in a manner compliant with applicable laws, rules and regulations. Recommendations made in the report will be studied and addressed by the Department's management team.

Thank you for the opportunity to address this Report. Please feel free to contact me with any questions you may have.

Sincerely,



Lisbeth C. Evans, Secretary
North Carolina Department of Cultural Resources

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In accordance with North Carolina General Statutes 147-64.5 and 147-64.6(c)(14), copies of this report have been distributed to the public officials listed below. Additional copies are provided to other legislators, state officials, the media, and the general public upon request.

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January 24, 2006

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